The Joint Committee on Taxation of
The Canadian Bar Association and
The Canadian Institute of Chartered Accountants

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November 3, 2004

Mr. Brian Ernewein,
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada
17th Flr., East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Mr. Ernewein:

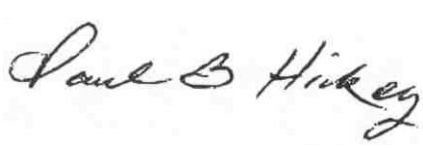
Re: Draft Submission in respect of the February 27, 2004, Draft Legislation--Proposed Amendments to the Foreign Affiliate Rules

Further to our previous discussions and communications with you and your officials, including our letter of October 8, 2004, we are enclosing our draft submission regarding the above.

Based on what we understand to be the government's current legislative timetable and priorities it has become apparent to us that we are not going to be able to complete this submission in final form in a timely manner. Therefore, in the interest of providing our comments assembled to date, we provide you with our draft submission. The draft submission incorporates many issues previously discussed with you and your officials. As you will appreciate, the topic area and the specific provisions are extremely complicated and new issues are arising on a regular basis. We will endeavor to communicate additional issues to you.

We would be pleased to meet with you once again to discuss these complicated issues and provide our input. As always, we appreciate the opportunity to discuss matters with you.

Yours very truly,



Paul B. Hickey

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Cc Mr. Wallace Conway, Chief Tax Legislation Division, Tax Policy Branch

SEJ:k
Enclosure

Submission of the CICA–CBA Joint Committee on Taxation in respect of the February 27, 2004, Draft Legislation Concerning Foreign Affiliates

Introduction

The February 27, 2004, Draft Legislation contains numerous proposals (the "Legislative Proposals") concerning the foreign affiliate rules in the *Income Tax Act* (the "Act") and the *Income Tax Regulations* (the "Regulations"). This Submission is intended to put forth the comments of the CICA–CBA Joint Committee on Taxation in respect of the more salient features of the Legislative Proposals.

Our Submission is divided into two main parts. The first part sets out our comments with respect to the conceptual and policy underpinnings of, as well as the practical considerations associated with, certain of the proposed amendments only – namely, those relating to Internal Dispositions, Reorganizations and Distributions, Surplus Adjustments and Subsection 93(1) Deemed Dividends, as well as certain comments on the regulations corresponding to paragraph 95(2)(a) of the Act. The second part consists of an Appendix, which catalogues a number of our more technical comments and recommendations.

Internal Dispositions, Reorganizations and Distributions

It is our understanding that many of the numerous changes proposed in relation to so-called "internal dispositions", reorganizations and distributions are intended to address concerns of the Department with respect to the "premature" realization and/or "duplication" of exempt surplus (and certain other tax attributes, such as ACB, or "foreign accrual property losses" ("FAPL")). While that objective may be understandable, we respectfully submit that the Department's approach as reflected by the Legislative Proposals gives rise to a number of quite serious concerns with respect to the implications of these measures.

We understand, moreover, that the Legislative Proposals relating to internal dispositions, reorganizations and distributions are being revisited by the Department, and it is in that context that our comments have been formulated. That is, we begin our review of this part of the Legislative Proposals with a discussion of the principles that we believe should govern this aspect of the foreign affiliate regime, and then continue in the Appendix hereto with a summary of numerous technical concerns that arise in relation to the Legislative Proposals as currently drafted, with a view to assisting the Department in its reconsideration of these measures both from a conceptual perspective and from a more technical standpoint.

Internal Dispositions

As noted above, we believe that it is understandable that the Department would be concerned about the "premature" realization and/or "duplication" of exempt surplus and other

relevant tax attributes. However, we submit that any measures introduced to address these concerns should be consistent with the following principles:

- Arm's Length Principle. These measures should not affect the treatment of transactions between parties dealing at arm's length.

  - We believe that it is inappropriate for transactions between parties dealing at arm's length to be treated as though they are somehow "artificial" and not worthy of recognition for these purposes. Normally, transactions between parties dealing at arm's length by definition carry all the badges of independent market dealings and, therefore, represent the most reliable indicators of realized economic value. Thus, to the extent that the surplus rules are intended to reflect the realized economic value within a particular foreign affiliate, then these transactions should in principle be recognized, subject to appropriate relief in certain cases.

  - The proposed income, gain and loss suspension rules for "internal dispositions" are similar in many respects to certain of the "stop-loss" rules applicable more generally for the purposes of the Act, such as subsection 40(3.4). In general terms, these rules may apply to suspend losses otherwise arising from transactions involving "affiliated persons". These rules are consistent with the arm's length principle, since "affiliated persons" in the corporate context normally share a control bond (or similar relationship).[1] The same is true for a wide range of other anti-avoidance rules scattered throughout the Act, from paragraph 13(7)(e) to section 247, and otherwise.

  - Accordingly, it is our view that any measures introduced to address these concerns in the foreign affiliate context should be applicable only in respect of transactions between persons that are not dealing at arm's length. Thus, the proposed definitions of "specified vendor" and "specified purchaser"[2] should be revised such that they include only persons that are not dealing at arm's length with the relevant taxpayer at the relevant time.

- Consistency/Neutrality. These measures should apply consistently and even-handedly, in a manner which maximizes fiscal neutrality in this context – that is, without regard to whether there is an accrued gain or loss on the particular asset.

  - The proposed income, gain and loss suspension rules for "internal dispositions" as currently drafted reflect what we believe to be an inappropriate bias. That is, income and gains from the disposition of excluded property can be suspended, but

[1] See the rules in section 251.1.

[2] See the definitions in proposed subsection 95(3.2) and following.

losses cannot. Similarly, losses from the disposition of non-excluded property can be suspended, but income and gains cannot.

- o It is submitted that the "validity" or "artificiality" of a particular transaction should be determined with reference to the circumstantial context in which it occurs (i.e., whether or not it occurs between parties dealing at arm's length), and not as a function of whether it produces a result which is favourable rather than unfavourable to the taxpayer or to the Crown. If a particular transaction should not be recognized because of the circumstantial context in which it occurs, then it seems unfair for the rules to depart from that approach for the singular purpose and only to the extent of imposing unfavourable consequences on the taxpayer.

- o Accordingly, it is our view that the scope of proposed paragraphs 95(2)(c.2) and (f.4) should not be restricted to dispositions of excluded property, and that of proposed paragraph 95(2)(h.1) should be expanded to apply to excluded property, or both should be abandoned.

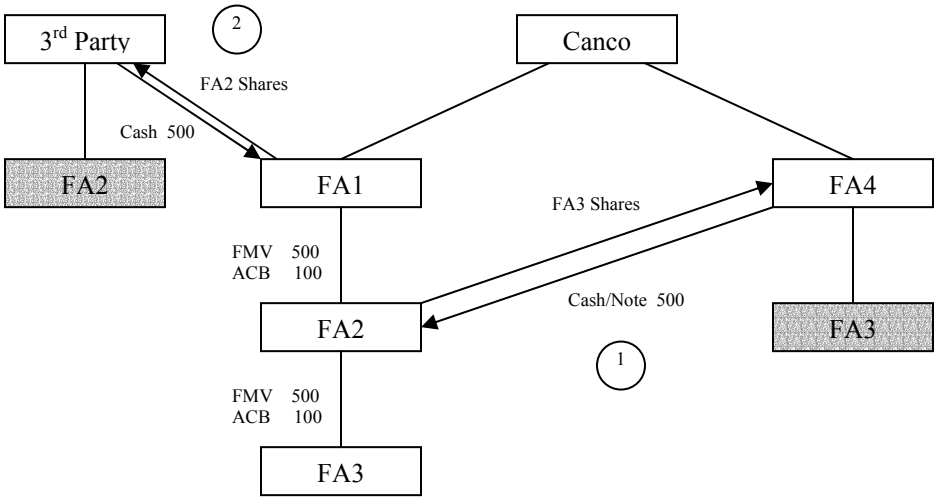
- Efficiency and International Competitiveness. These measures should not introduce inordinate administration and compliance burdens into the system, or improvidently interfere with the ability of Canadian-based multinational enterprises to arrange and restructure the affairs of their corporate groups in such a manner as to maximize their international competitiveness.

  - o There are three aspects of the Legislative Proposals which we believe are inconsistent with these very important principles. First, there is the aspect of these measures which introduces the notion of suspended income, gains and losses (as opposed to simply introducing another category of surplus or deficit and perhaps grafting it onto the existing infrastructure in the Regulations). Second, there is the aspect of these measures which can result in the realization of FAPI in respect of a disposition of excluded property, rather than simply preventing or discouraging the *Canadian use* of any exempt surplus (or FAPL or other relevant tax attribute) otherwise arising. Third, there is the aspect of these measures that regulates the "unsuspension" or "release" of the suspended items, which does not sufficiently accommodate structured divestitures and certain very important timing considerations.

  - o While the more general concern from the Department's perspective may be described in part as the "premature" realization of exempt surplus and other tax attributes, we understand that one of the more important specific manifestations of this concern arises in relation to the repatriation of economic value into Canada on the basis of such "premature" attributes. That is, we understand that the Department may in certain cases be concerned about circumstances in which, for example, exempt surplus arises from an "internal disposition" of shares of a

foreign affiliate that constitute excluded property, and then this exempt surplus is used, given the ordering rule in Regulation 5901, to repatriate to Canada economic value which reflects realized taxable surplus unsupported by sufficient underlying foreign tax.

o It is submitted that this concern, while understandable, falls short of justifying the introduction of as intrusive a regime as that reflected in the Legislative Proposals. Moreover, it is submitted that the proposed regime could well be completely ineffective in addressing this concern in many cases, and would produce harsh and otherwise inappropriate results in other cases. Consider the following example:



Essentially, FA2 sells FA3 to FA4 in consideration for cash or a promissory note. Proposed paragraph 95(2)(c.2) would suspend the gain that would otherwise result. FA1 then sells FA2 to a 3rd Party. The gain realized here would reflect the same economic gain as that inherent in the FA3 shares, but proposed paragraph 95(2)(c.2) would not suspend this gain. Moreover, since the gain that would otherwise result from the sale of FA3 by FA2 is suspended, the gain from the sale of FA2 by FA1 would not be reduced by subsection 93(1.1). Thus, the gain from the sale of FA2 by FA1 may produce FAPI or not, depending on whether the FA2 shares are excluded property at the time of their sale, but will in any event produce unsuspended surplus.

o It is submitted that this concern could be addressed by the introduction of a new category of surplus, which could be regarded as "suspended surplus", and which could be grafted onto the existing infrastructure in the Regulations. This approach would permit "suspended surplus" to be used to transfer economic value

between foreign affiliates, but not to repatriate economic value into Canada ahead of taxable surplus.

- Essentially, the principal features of this alternative approach could be summarized as follows:

  - All income, gain or loss from an "internal disposition" of excluded property would result in "suspended surplus" or "suspended deficit", except to the extent that it would otherwise be accounted for in computing "taxable surplus" or "taxable deficit", and only until the relevant "release event" occurs. In other words, "suspended surplus" or "suspended deficit" would include only what would otherwise be included in exempt surplus or deficit. What would otherwise be included in taxable surplus or deficit would not be suspended.

  - Dividends considered to be paid out of such surplus would be excluded from the FAPI of a foreign affiliate, and would be deductible in the hands of a corporate taxpayer resident in Canada only to the extent of any grossed-up withholding or underlying foreign tax applicable thereto. In brief, they would be treated in the same manner as dividends paid out of taxable surplus.

  - Once a "release event" occurs, then the "suspended surplus" or "suspended deficit" would be accounted for in computing exempt surplus or deficit. In the meantime, such "suspended surplus" or "suspended deficit" could be moved from one foreign affiliate to another, and could be adjusted or consolidated in the event of a change to the relevant taxpayer's surplus entitlement percentage ("SEP") or a relevant foreign affiliate reorganization.[3]

  - Since such "suspended surplus" would be treated in the same manner as taxable surplus, it could not be used to repatriate economic value to Canada on a tax-free basis except to the extent that an appropriate amount of foreign withholding or underlying tax has already been paid.[4]

  - Release events would include circumstances in which the relevant vendor affiliate ceased to deal at arm's length with the relevant taxpayer, as well

[3] For example, if FA1 had a "suspended deficit" and FA2 had "suspended surplus", and FA1 received a dividend from FA2 out of the latter's "suspended surplus", then that "suspended surplus" dividend would offset FA1's "suspended deficit", and so on.

[4] It would be our suggestion in this regard that a separate UFT pool be maintained for each of "taxable surplus" and "suspended surplus".

as those in which the relevant property ceased to be held by a person not dealing at arm's length with the relevant taxpayer (either because the relevant property or the relevant holder was disposed of to an arm's length party, or ceased to exist in certain cases). Timing issues would also be addressed in such a manner as to ensure that these measures would not apply in the context of structured divestitures (i.e., where the relevant property has left the non-arm's length group within 30 days), and to ensure that any "suspended surplus" would become available immediately before an arm's length disposition of the relevant affiliate, particularly where the specified property exits the non-arm's length group at the time of the arm's length disposition of the relevant affiliate (i.e., where the specified property is "downstream" of the relevant affiliate).

- The advantages of this approach would seem to include the following:

  - Because this new category of "suspended surplus" could be grafted onto the existing infrastructure in the Regulations, there would be no need to develop alternative infrastructure to address surplus tracking and continuity issues arising in the context of changes to the relevant taxpayer's SEP or various types of corporate reorganizations.

  - By grafting this new category of "suspended surplus" onto the existing infrastructure in the Regulations, the Department would ensure that the surplus consequences of changes to the relevant taxpayer's SEP or various types of corporate reorganizations would be the same (i.e., appropriately analogous) in the context of realized surplus as in the context of "suspended surplus", so it would be less likely that anomalies could arise that could either be exploited by taxpayers or work to their disadvantage in particular circumstances.[5]

  - This approach would reduce administrative and compliance costs because it would be implemented using existing legislative infrastructure in respect of which both the CRA and taxpayers already have established processes. This would avoid the need to develop new administrative and compliance processes, as well as the associated costs.

[5] As a further example, because this approach would permit "suspended surplus" to be used to transfer economic value between foreign affiliates, it would not require the development of a whole new set of rules to govern the application and interaction of subsection 40(3). We would note, however, that dispositions arising because of the application of subsection 40(3) should be treated as "internal dispositions" only if the relevant taxpayer and the issuing affiliate do not deal at arm's length.

- Since this "suspended surplus" would be treated in the same manner as taxable surplus, the Canadian tax base would be fully protected, and there would be no need to require the recognition of FAPI as a condition of surplus recognition.[6]

- Since this approach would permit "suspended surplus" to be used to transfer economic value between foreign affiliates, it would not in any way interfere with the ability of Canadian-based multinational enterprises to arrange and restructure their foreign corporate groups in such a way as to maximize their international competitiveness. We would emphasize that it is very important not to lose sight of the fact that "internal dispositions" are essential tools in the context of structuring and restructuring Canadian-based multinational corporate groups with a view to minimizing foreign costs, including foreign tax and regulatory burdens, and thereby maximizing Canadian competitiveness and wealth.

We would be pleased to discuss this alternative approach with you in greater detail should you be interested in so doing. In addition, with reference to the Legislative Proposals as currently drafted, we offer the more technical recommendations set out in the Appendix hereto.

Reorganizations

A wide range of revisions is proposed in relation to the foreign affiliate rules in the Act and Regulations governing the consequences of certain reorganizations. We refer, in particular, to proposed new paragraphs 95(2)(d) to (e.1), and related provisions.

These proposed revisions appear to be animated significantly by the same concerns as those reflected in the proposed new income, gain and loss suspension rules. That is, in large measure, these proposed revisions would restrict the recognition of surplus otherwise arising in the context of a foreign merger or liquidation. However, in our view, these proposals would appear to go beyond that consequence in important respects, resulting in some cases in the inappropriate recognition of FAPI.

Foreign Mergers

With respect to the aspects of these revisions which are driven by the same concerns as those reflected in the proposed new suspension rules, we would submit the same

[6] We would nevertheless acknowledge that FAPI recognition could still serve as a condition of *exempt surplus* recognition. That is, FAPI recognition could be a condition to the relevant taxpayer electing to opt out of the "suspended surplus" rules in respect of a particular "internal disposition", in which case any income or half of any gain would be FAPI. Presumably, taxpayers may choose to do so if the disposition results in sufficient underlying foreign tax.

recommendation – namely, that any new rules developed in this context should be consistent with the general principles set out above in relation to the suspension rules – subject to the caveat that the reorganization context may give rise to certain particular considerations and concerns.

- Arm's Length Principle, and Consistency. It is submitted that there is no need to distinguish in this context between circumstances in which the relevant taxpayer has or does not have a SEP of at least 90% in the relevant foreign affiliate(s). Moreover, if any such distinction is to be made, on the basis of the taxpayer's percentage interest in the relevant foreign affiliate(s), then it is submitted that this distinction should be based on whether or not the taxpayer deals at arm's length with the relevant foreign affiliate(s), not based on the taxpayer's SEP in the relevant affiliate(s), and certainly not based on a 90% ownership threshold. We will return to the latter point below.

    - The SEP standard is problematic in this context, since there can be circumstances in which a taxpayer can have *nil* SEP in respect of an indirect wholly-owned foreign affiliate,[7] and there can be circumstances in which a taxpayer can have a SEP of 100% in respect of a particular affiliate even though the taxpayer holds less than 100% of the affiliate's equity.[8] Thus, it is submitted that the SEP standard is simply not a reliable indicator of the relationship between a relevant taxpayer and a particular foreign affiliate.

    - Foreign mergers normally result in a pooling of interests in the underlying corporate assets, without any exchange or extraction of a substantial amount of cash or near-cash consideration, and therefore in our view should not be treated as taxable transactions, even for arm's length shareholders, assuming that the terms of the definition of "foreign merger" in subsection 87(8.1) are satisfied.

        - There is no minimum percentage interest requirement that applies under section 87, whether in the domestic or in the international context. That is, at the shareholder level, subsection 87(4) applies (either on its own in the domestic context or in conjunction with subsections 87(8) and (8.1) in the international context) regardless of the taxpayer's percentage interest in

[7] For example, where Taxpayer holds FA1 (which has a net deficit of, say, $100) and FA1 holds FA2 (which has net surplus of, say, $100), and either FA1 or FA2 has more than one class of shares outstanding. In such a case, the formula applicable under Regulation 5905(13) and related provisions would yield a SEP of *nil* in respect of the taxpayer even in this wholly-owned context.

[8] For example, where Taxpayer holds 100% of a class of an affiliate's shares, and another person holds 100% of another class of the affiliate's shares, and the two classes rank equally with respect to dividends and other distributions, the formula applicable under Regulation 5905(13) and related provisions would yield a SEP of 100% in respect of the Taxpayer at any time at which the affiliate had *nil* net surplus.

the relevant corporation(s). The same is true under proposed paragraph 95(2)(d) and subsections 87(4), (8) and (8.1).[9]

- The anomaly arises at the asset level. Under domestic corporate law, an amalgamation does not normally result in the disposition of property (other than cross-shareholdings and similar items). Thus, although section 87 does not deem the relevant predecessor corporations to have disposed of their properties at tax cost, the underlying assumption of the Act in the domestic context is that there is no disposition as a matter of the governing corporate law, so there is no need for a statutory rollover.[10] In the foreign context, however, that assumption cannot be made, in that the corporate law applicable in various foreign jurisdictions does indeed result in a disposition of predecessor property, particularly where the relevant predecessor does not "survive" the merger.

- Thus, it would be appropriate in our view for proposed paragraph 95(2)(d) to provide for a rollover in respect of any predecessor property which is disposed of in the course of the merger (provided that, as a result of the merger, such property either becomes property of the corporation resulting from the merger or is extinguished by operation of law under the doctrines of merger, confusion or any similar doctrine or principle) and this, without regard to whether or not the property in question constitutes excluded property, and without regard to the taxpayer's percentage interest in the relevant predecessor affiliate.

- In stark contrast, however, proposed paragraph 95(2)(d) not only lacks a rollover in respect of non-excluded property, but in addition deems all non-excluded property to have been disposed of for fair market value consideration even if there is no disposition of such property as a matter of the governing corporate law, all the while deeming excluded property to have been disposed of at tax cost. It is respectfully submitted that this provision, as currently drafted, reflects a considerable bias adverse to taxpayers. This rule never helps the taxpayer – on the contrary, it suppresses exempt surplus from the disposition of excluded property, and it forces the recognition of unrealized FAPI.

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[9] Oddly, voluntary partial gain recognition is permitted only in respect of shares that are excluded property, even though a FAPI addition results from any such gain recognition as if the shares were not excluded property. It is difficult to understand the reason(s) for this distinction.

[10] Reference can also be made to proposed new paragraph (n) of the definition of "disposition" in subsection 248(1), which would deem there not to have been any disposition of certain property (e.g., certain cross-shareholdings) on a qualifying domestic amalgamation or foreign merger.

- Proposed paragraph 95(2)(d) must be read together with proposed paragraph 95(2)(d.1). Although the primary dividing line for the application of proposed paragraphs 95(2)(d) and (d.1) would continue to be the 90% SEP threshold,[11] that would not be the only one. That is, proposed paragraph 95(2)(d.1) would not apply to a foreign merger:

  > … where, under the income tax law of the country in which the predecessor foreign corporations were resident immediately before the merger, any income, gain or loss was recognized in respect of any property of a predecessor foreign corporation that became property of the new foreign corporation in the course of the merger …

  Thus, where the merger is a non-recognition transaction under the relevant foreign tax law, or where there is no relevant foreign tax law (i.e., where the predecessors are resident in a country that does not have an applicable tax law, or are resident in different countries), proposed paragraph 95(2)(d.1) can apply. Otherwise, it would appear that the application of proposed paragraph 95(2)(d) would not be displaced by proposed paragraph 95(2)(d.1), even if the 90% SEP requirement were met. This is a particularly troubling observation – FAPI could be realized on the merger of two wholly-owned foreign affiliates simply because the transaction is a recognition transaction, with respect to some property, under the applicable foreign tax law.[12]

- If an asset-level rollover is provided for without regard to the relevant taxpayer's percentage interest in the particular affiliate(s), it would seem to be possible for the taxpayer to avoid future FAPI in respect of an accrued gain on non-excluded property of its CFA, by causing the CFA to be merged with another entity in a dilutive horizontal merger, thereby experiencing a dilution of the taxpayer's percentage interest in the CFA and a consequential reduction of future FAPI attribution. However, this is a "sword" that "cuts both ways", in that a merger would normally likewise result in a corresponding reduction of future exempt surplus in respect of any accrued income or gain on excluded property of the CFA. In other words, since there is no mechanism to adjust the amount of any future FAPI or exempt surplus as a function of any change to a relevant

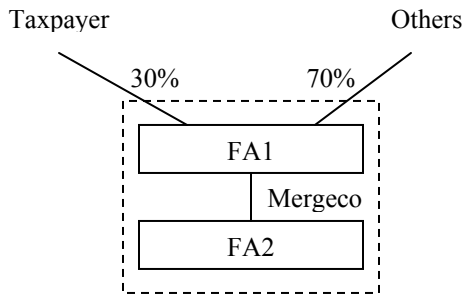
[11] A similar dividing line is drawn between proposed paragraphs 95(2)(e) and (e.1).

[12] Although this aspect of proposed paragraph 95(2)(d.1) is essentially the same as under current law, the effect is different because, under current law, paragraph 95(2)(d) does not result in a deemed disposition of non-excluded property.

taxpayer's SEP as between the time when the income or gain accrued and the time it is realized, a merger always produces "slippage" (whether positive or negative from the taxpayer's perspective). Although we would not recommend that a mechanism be introduced to address this type of "slippage", it is our submission that the existence of the possibility of such slippage does not justify restricting access to the asset-level rollover to non-arm's length (or greater percentage interest) circumstances.

- This type of "slippage" also arises where a taxpayer's percentage interest in respect of a particular affiliate is diluted because of a share issuance by the particular affiliate. It would seem pointless to address "slippage" in the context of a merger but not otherwise.

- There would be many circumstances in which a merger does not result in any change to the relevant taxpayer's percentage interest in the particular affiliate – and, therefore, does not result in any such "slippage". A compelling case can certainly be made for an asset-level rollover in this context, regardless of the relevant taxpayer's percentage interest in the particular affiliate. Consider the following example:



In this example, FA2 was a wholly-owned subsidiary of FA1, until the merger. Before the merger, the Taxpayer's percentage interest in FA2 was 30%, which is the same as the Taxpayer's percentage interest in FA2 after the merger. Clearly, there can be no "slippage" of the kind described above in such circumstances, and therefore there would seem to be no reason to deny a rollover at the asset level, regardless of the taxpayer's percentage interest in particular affiliate. This example illustrates a true case of change in form alone, which in our view should never result in any Canadian tax cost.

- At a minimum, even if an asset-level rollover is not provided for under proposed paragraph 95(2)(d), it is our submission that this provision should be modified such that there would be no deemed disposition of property which is not disposed of as a result of the merger as a matter of the governing corporate law.

  - For an entity that "survives" a foreign merger, the merger is equivalent to an asset acquisition in exchange for shares.

  - It would seem inappropriate for the Act to deem a "surviving" affiliate to have disposed of any of its assets when the Act does not deem an affiliate to have disposed of any of its assets when it carries out a direct asset acquisition in exchange for shares.

- Efficiency and International Competitiveness. It is submitted that the Canadian tax consequences of a foreign merger should not depend on the foreign tax consequences of the merger. That is, even if the Act should continue to draw a distinction between foreign mergers based on the relevant taxpayer's percentage interest in the particular affiliate(s), it is submitted that this should be the only basis of distinction, and no additional conditions should be imposed under proposed paragraph 95(2)(d.1), especially not conditions based on the application of foreign law.

- It is our submission that the Canadian tax consequences of a foreign merger should be determined with reference to the circumstantial context in which it occurs, and not as a function of its foreign tax consequences. Other countries may have other priorities, and certainly would not have the international competitiveness of Canadian multinationals as a priority. Thus, the foreign tax rules do not necessarily reflect Canadian principles and priorities, and therefore should not be determinative of Canadian tax consequences.[13]

- If a particular foreign merger results in the imposition of foreign tax, it may be desirable for the taxpayer to elect to also recognize some income or gain for Canadian tax purposes, in order to utilize that foreign tax. This is a context in which it would perhaps be useful to maintain a distinction between proposed paragraphs 95(2)(d) and (d.1). The former could apply to produce a rollover at the asset (and shareholder) level, and the latter could permit taxpayers to elect to recognize some income or gain. Where a taxpayer elects to do so, that income or gain could be subjected to the same treatment as any income or gain arising from an "internal disposition", as described above, producing "suspended surplus" (treated like taxable surplus), or exempt surplus, in the case of a capital gain, on the condition of FAPI recognition for the taxable portion. Access to this elective regime could be restricted to circumstances in which the relevant taxpayer does not deal at arm's length with the particular affiliate(s), or in which the particular affiliate is a CFA.

- Another aspect of these Legislative Proposals which is troublesome in our view, as currently drafted, is that proposed paragraph 95(2)(d) does not provide for broad entity and attribute continuity. Thus, where a predecessor ceases to exist as a result of a foreign merger, nothing continues all the accounts and other attributes of the predecessor in the "successor".

- Recommendations. In summary, it is submitted that the foreign merger rules in proposed paragraphs 95(2)(d) and (d.1) should be revised in accordance with the following principles:

  - Paragraph 95(2)(d) should apply in respect of all taxpayers, regardless of their percentage interest in the particular affiliate(s), and should provide an asset-level rollover for both excluded property and non-excluded property, regardless of the foreign tax consequences, if any, of the merger. At a minimum, paragraph 95(2)(d) should not provide for any deemed disposition of the property of corporation that "survives" the merger.

[13] For example, while we rely to some extent on foreign tax rules to compute earnings from carrying on an active business, this is not the case for FAPI, and even in the context of computing active business income we make certain adjustments under Regulation 5907(2) and other provisions.

- Paragraph 95(2)(d.1) should permit voluntary income or gain recognition both at the asset and at the shareholder level. Access to such elective income or gain recognition could be restricted to circumstances in which the taxpayer is not dealing at arm's length with the particular affiliate or where the affiliate is a CFA.

- Any such voluntary income or gain would be subject to the "suspended surplus" rules, as described above, producing "suspended surplus" (treated like taxable surplus), or exempt surplus, in the case of a capital gain, on the condition of FAPI recognition for the taxable portion.

- Paragraph 95(2)(d) should also provide for broad entity and attribute continuity.

We would also draw your attention to the more technical points we raise in relation to foreign mergers as set out in the Appendix hereto.

Foreign Liquidations

Many of the comments made above would be equally applicable in the context of the rules governing foreign liquidations. In particular, we refer to our comments on access to the asset-level rollover for non-excluded property in respect of taxpayers who may not have a 90% SEP in respect of the particular affiliate(s).

However, a number of additional concerns arise in relation to the proposed amendments to subsection 88(3), applicable to liquidations directly into Canada. There are three main areas of concern here.

- The recognition of FAPI on the distribution of excluded property.

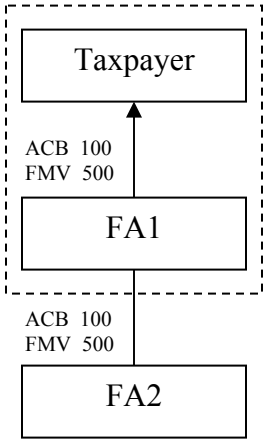
- The timing of surplus recognition and availability.

- The release of "suspended income or gain" pre-existing the liquidation.

As a matter of general principles, and the application of section 69, the liquidation and dissolution of a foreign affiliate would normally result in the realization of any accrued income or gain in respect of the property of the liquidating affiliate and in respect of its outstanding shares, determined as a function of the relevant proceeds of disposition, in turn determined as a function of relevant fair market values. In certain circumstances, however, it is considered to be appropriate to provide relief against income or gain recognition, in view of the "formalistic" nature of the transaction, or based on other relevant considerations.

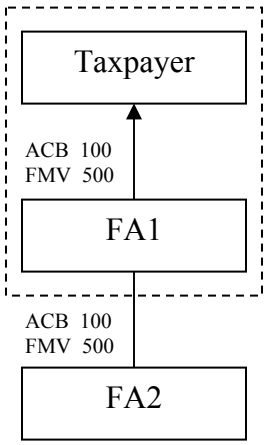
It is respectfully submitted that the following principles could serve as appropriate guideposts in formulating revisions to these very important rules in subsection 88(3), as they apply in the context of a liquidation:

- FAPI should never arise from the distribution of shares of another foreign affiliate of the taxpayer that constitute excluded property, even where the taxpayer elects that the liquidating affiliate's proceeds of disposition be increased above its ACB in the distributed property. There is one very compelling reason for this – namely, that, as a result of this election, the taxpayer's proceeds of disposition of its shares in the liquidating affiliate will increase immediately and in the same amount as the liquidating affiliate's proceeds are increased, such that the relevant gain will be "recognized" immediately and directly in Canada without recourse to the attribution of any FAPI. In brief, FAPI attribution is not necessary because the gain will in any event be "recognized" immediately and directly in Canada. Consider the following examples:



	FAPI on Gain	No FAPI on Gain
PROCEEDS (with RBC election)	500	500
FAPI resulting	200	nil
92 ACB Adjustment	200	nil
ES resulting	200	200
TS resulting	200	200
GAIN on FA1 Shares before 93(1)	400	400
GAIN of FA1 shares after 93(1) at 400	nil	nil
ES dividend	200	200
TS dividend	200	200
91(5) deduction	200	nil
Taxable Income	**200**	**200**
RESULTING ACB in FA2	500	500

As this example clearly illustrates, FAPI attribution on the gain resulting from the RCB election does not in any way increase the taxable income of the taxpayer. Therefore, this measure cannot be justified as a means of appropriately protecting the Canadian tax base. The real issue is whether or not taxpayers should be permitted to achieve even "better" consequences than those illustrated above. There are two examples we would consider to be relevant in this regard, each assuming that no FAPI would arise on the gain resulting from the RCB election, as follows:



	Case A	Case B	Case C
PROCEEDS (with RCB election)	500	500	500
ES resulting	200	200	200
TS resulting	200	200	200
GAIN on FA1 Shares before 93(1)	400	400	400
93(1)	nil	200	400
ES dividend	nil	200	200
TS dividend	nil	nil	200
TAXABLE GAIN on FA1 shares after 93(1)	200	100	nil
Taxable dividends	nil	nil	200
Taxable Income	200	**100**	200
RESULTING ACB in FA2	500	500	500

As this example clearly illustrates, the only circumstance in which there can be a concern from the Crown's perspective is where the taxpayer is permitted to "cherry-pick" the surplus arising from the gain resulting from the RCB election (Case B above). If a 93(1) election is not made at all (Case A above), the tax consequences are appropriate, in that the taxpayer recognizes a gain of 400, and taxable income of 200. If a 93(1) election in an amount no less than the gain resulting from the RCB election is made (Case C above), again the tax consequences are appropriate, in that the taxpayer recognizes no gain but has taxable income of 200 resulting from a deemed taxable surplus dividend. Only where the taxpayer makes a 93(1) election equal to the exempt surplus resulting from the RCB election (Case B above) is there any concern from the Crown's perspective, but only to the extent that the taxpayer effectively doubles-up on the exempt portion of the capital gain.

Thus, in order to address this concern, it is our recommendation that a taxpayer making a subsection 93(1) election in the context of a liquidation to which subsection 88(3) is applicable be required to elect an amount which is not less than the lesser of:

(a) the capital gain that the taxpayer would realize from the disposition of the shares of the liquidating affiliate if no such election were made, and

(b) the entire amount of any capital gain resulting from a RCB election made in connection with the liquidation.

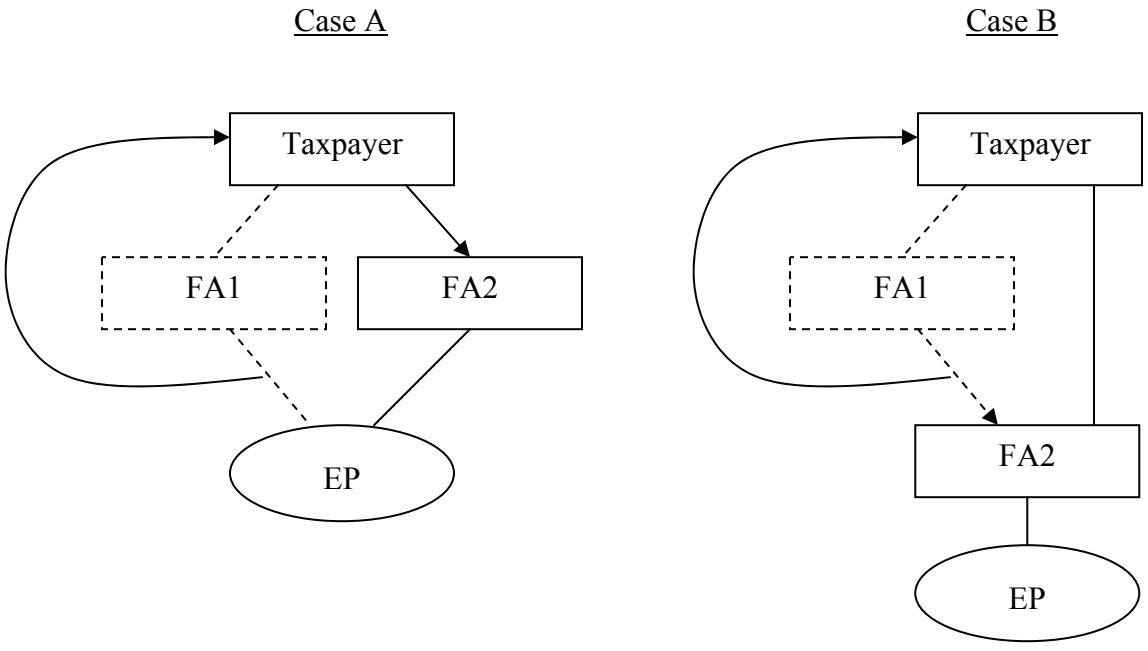
This would fully address the Crown's concern without subjecting taxpayers to inordinate and inappropriate taxation. In our submission, taxpayers should be permitted to recognize gains resulting from RCB elections in respect of excluded property as capital gains, and taxable capital gains, rather than as attributed FAPI. Capital gains can be offset with capital losses which taxpayers may have, but attributed FAPI cannot be offset with capital losses. In addition, capital gains result in additions to a corporate taxpayer's capital dividend account, whereas FAPI does not. These are very important pillars of the Canadian income tax regime (the ability to offset capital losses against capital gains and the ability for a private corporation to distribute the exempt portion of its capital gains on a tax-free basis through its CDA), and should not be undermined under the Legislative Proposals.

- The distribution of appreciated property other than excluded property to a taxpayer resident in Canada should be permitted to occur on a non-recognition or "rollover" basis. For this, too, there is one very compelling reason – namely, that non-recognition treatment results in the "importation" of a latent gain (or income) which, when the relevant property is subsequently disposed of in a recognition transaction, will result in taxable income under the Act. In other words, it seems inappropriate to deny a rollover where the gain in question is being shifted into the Canadian tax net. After all, the very purpose of the FAPI regime is to bring into the Canadian tax net what would otherwise be

outside its parameters. By bringing the property directly into Canada on a rollover basis, the taxpayer has permanently conceded taxing jurisdiction in respect of the latent gain to Canada. Moreover, since rollover treatment in this context results in the "importation" of latent gain, and therefore cannot adversely affect the Crown, it is our view that it should be permitted regardless of the taxpayer's percentage interest in the liquidating foreign affiliate.

- The timing rules applicable in this regard for surplus computation purposes should be structured so that they clearly permit the use, pursuant to subsection 93(1), of surplus arising from dispositions that occur in the course of the liquidation. This is the case in our view under the current version of Regulation 5907(9), but may not be the case under proposed Regulation 5907(9) as currently worded. Moreover, assuming that this concern were addressed (for example, by adding a timing rule into proposed Regulation 5907(9)(b)(i) deeming the disposition to have occurred "immediately before the end of the affiliate's taxation year deemed to have ended by paragraph (a)", like the rule under current law), it would also be necessary to ensure that the resulting surplus would be available under subsection 93(1).

- The final liquidation and dissolution of a foreign affiliate should release any "suspended" income or gain it may have, such that these items may be taken into account for final surplus computation purposes as described above. If these "suspended" items are not released at this time, they will be lost, which is inappropriate. More importantly, however, we note that since income and gains are not and should not be "suspended" where they arise from dispositions resulting from liquidation distributions into Canada, the liquidation of a foreign affiliate should release any of its "suspended" income or gains. Consider the following comparison:



In Case A, FA1 distributes excluded property to the taxpayer on its final liquidation, thereby realizing all accrued income and gains, and corresponding surplus, which is available for subsection 93(1) purposes. The cost to the taxpayer of the property equals its value, and the taxpayer does not realize any taxable income or capital gain from the disposition of its FA1 shares because a subsection 93(1) election is made (this assumes the taxpayer's ACB of its FA1 shares was not less than FA1's ACB and other cost of its property). The taxpayer then transfers the property to FA2, in exchange for shares of FA2, resulting in the taxpayer having ACB equal to value in the FA2 shares, and FA2 having ACB and other cost equal to value in the underlying property. Arguably, it should be possible to achieve the same results and tax attributes in Case B, where the order of steps is simply reversed but the corporate and commercial result is identical. That is, FA1 first transfers the property to FA2, then distributes the FA2 shares to the taxpayer on its liquidation. Any "suspended" income or gain that arose on the preliminary transfer to FA2 should be released and be available on the liquidation of FA1 in the same manner as it would be if such income and gain had been realized on the liquidation as such rather than on the preliminary transaction.

We would also draw your attention to the more technical points we raise in relation to foreign liquidation as set out in the Appendix hereto.

Distributions

The Legislative Proposals would substantially expand the circumstances in which corporate property can or must be distributed to its shareholders on a non-recognition or rollover basis outside of the context of a liquidation of the distributing corporation. More specifically, new rules would be introduced governing the distribution of the property of a foreign affiliate by way of a dividend or other distribution in kind, or on the redemption, acquisition or cancellation of a share of the distributing affiliate, whether into Canada (as contemplated by proposed subsection 88(3)) or to another foreign affiliate of the relevant taxpayer (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)).

In general terms, a fair market value disposition would be prescribed in respect of distributions into Canada (as contemplated by proposed subsection 88(3)), except in respect of the distribution of shares of another affiliate that constitute excluded property, unless an RCB election is made, as discussed above in the context of liquidations. In the foreign-to-foreign context (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)), rollover treatment would be prescribed in respect of dispositions of excluded property (with FAPI treatment for any income or gain resulting from an RCB election), and a fair market value disposition would be prescribed in respect of distributions of non-excluded property.

As noted above, it is our view that such a bias is inappropriate in this context. The rules should be even-handed as between distributions of excluded property and non-excluded property (that is, a rollover should be available in either case), although we would understand that income

and gains resulting from RCB elections in this context from foreign-to-foreign dispositions of excluded property could in some cases be subjected to "suspended surplus" treatment as described above. Indeed, it seems somewhat curious that a rollover would be available for non-excluded property distributed on a liquidation governed by proposed paragraph 95(2)(e.1), but not available in respect of the same property distributed to the same shareholder by way of a dividend in kind governed by proposed paragraph 95(2)(e.3).[14]

It is respectfully submitted that these proposed amendments should be structured in a manner which is consistent with the following principles, in addition to those articulated above in relation to internal dispositions and liquidations:

- As a default, property distributed by a foreign affiliate to the taxpayer (as contemplated by subsection 88(3)), that constitutes shares of another foreign affiliate of the taxpayer (or of a corporation that would as a result of the distribution become another foreign affiliate of the taxpayer), should be deemed to be disposed of at its cost amount, regardless of whether or not the shares are excluded property. The taxpayer should be permitted to make a RCB election, and any income or gain that results therefrom should give rise to a FAPI inclusion only if the property is not excluded property. Any such income or gain should not be "suspended" for surplus computation purposes. If the property is distributed by way of a dividend in kind (including deemed dividends), there is no concern with respect to the taxpayer "cherry-picking" the exempt surplus resulting from the RCB election, because the amount of the dividend will increase in the same amount as the distributing affiliate's proceeds are increased by the RCB election.[15] If the property is distributed on a redemption, acquisition or cancellation of shares of the distributing affiliate, or as a return of capital, and the taxpayer makes a subsection 93(1) election, this "cherry-picking" concern does not really arise in the same way because current-year surplus cannot be used in the context of a subsection 93(1) election (except on a liquidation)[16] and, in any event, can be addressed at least in part by requiring the taxpayer to elect an amount which is not less than the lesser of the gain resulting from the RCB election and the gain otherwise resulting from the disposition of the shares of the distributing affiliate, as noted above.

[14] The same can be said in respect of distributions governed by subsection 88(3) – that is, that it seems somewhat curious that a rollover would be available for non-excluded property distributed on a liquidation governed by proposed paragraph 95(2)(e.1), but not available in respect of the same property distributed to the same type of shareholder in the context of a transaction governed by subsection 88(3), be that a liquidation or other distribution.

[15] It should be noted that the dividend would be considered to have been paid out of surplus arising from the RCB election only to the extent that the dividend is paid after the first 90 days of the affiliate's taxation year, in accordance with Regulation 5901(2).

[16] See Regulations 5901(2) and 5907(9).

- As for the amount and character of the dividend, distribution or proceeds from the Canadian taxpayer's perspective, we would make the following recommendations:

  - All amounts should be determined as a function of the deemed proceeds of disposition of the distributed property to the distributing affiliate.

  - Amounts distributed legally as dividends in kind should be characterized as dividends.

  - Amounts distributed legally other than as dividends in kind or redemption or other disposition proceeds (i.e., distributions in the form of returns of capital or other legal distributions of property) should be characterized as returns of capital to the extent that the recipient is recovering the cost of its investment – that is, to the extent of the ACB to the recipient of the shares of the distributing affiliate on which such distributions are made – with any excess being characterized as a dividend (and, in turn, as an exempt surplus, taxable surplus or pre-acquisition surplus dividend, in accordance with applicable ordering rules).[17] This approach would permit a shareholder to recover its actual cost of an investment, but would not permit the legal capitalization of retained earnings to be extracted as capital gains. To be clear, it is our view that legal distributions (as opposed to improper appropriations) exceeding the amounts treated as returns of capital should result in deemed dividends, and not result in non-dividend income to the taxpayer or any subsection 15(1) or similar benefit inclusion.

  - Finally, redemption or other disposition proceeds should be characterized as such, except to the extent that a subsection 93(1) election is made.

- Similar principles should be applicable in the context of foreign-to-foreign distributions to specified purchasers (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)), subject to the following:

  - Income and gains resulting from a RCB election in respect of excluded property should not result in FAPI attribution, but rather in "suspended surplus" as described above, treated in the same manner as taxable surplus unless and until a

[17] Moreover, we understand that the Department is presently considering the adoption of a specific definition of "paid-up capital" which would be applicable for these purposes (and which we will refer to as "foreign paid-up capital" or "FPUC"), and that this definition would include all amounts contributed to a corporation by a shareholder or as consideration for the issuance of its shares (whatever the designation of those amounts may be for foreign corporate law purposes, be it "share premium", "contributed surplus" or some other designation). We believe the cost-recovery approach suggested above would be a simpler and more appropriate approach in these circumstances.

relevant release event occurs – unless the taxpayer elects FAPI treatment.[18] Moreover, it seems inappropriate, and not even-handed, for the proposed description of B in the definition of FAPI to continue to include a portion of gains arising from the disposition of excluded property in certain reorganization circumstances, when the proposed description of E in the definition of FAPI is being amended to specifically exclude losses arising from the disposition of excluded property in such circumstances.

- Redemption or other disposition proceeds should be characterized as such, except to the extent that a subsection 93(1) election is made or is deemed to be made in accordance with proposed subsection 93(1.1).

- Taxpayers should be permitted to suppress the recognition of gains arising in respect of shares that are not excluded property and which arise in respect of a transaction governed by proposed paragraph 95(2)(e.3) to (e.5), whether by reason of the application of subsection 40(3) or otherwise.

- Gains arising in respect of shares that are excluded property, whether by reason of the application of subsection 40(3) or otherwise, should simply be subjected to the "suspended surplus" rules described above.

We would also draw your attention to the more technical points we raise in relation to foreign distributions as set out in the Appendix hereto.

Surplus Adjustments and Subsection 93(1) Elections

The Legislative Proposals introduce a number of significant changes to the provisions that determine when and to what extent the surplus balances of an affiliate, or group of affiliates, whose shares are disposed of, may be accessed, other than by paying dividends, in accordance with subsection 93(1). These proposals limit the amount of a subsection 93(1) election to the lesser of the proceeds of disposition of the disposed share and the amount "prescribed", determined by reference to a new "consolidated net surplus" regime. This new regime is intended essentially to offset available surplus by the amount of any deficits in the relevant foreign affiliate chain. In addition, a new adjustment rule would reset the surplus, deficit and underlying foreign tax balances of the relevant affiliates in the event that a subsection 93(1) election is or is deemed to be made in respect of most internal dispositions, and another rule would adjust the ACB of the relevant inter-affiliate shareholdings for certain purposes to reflect these resets and adjustments.

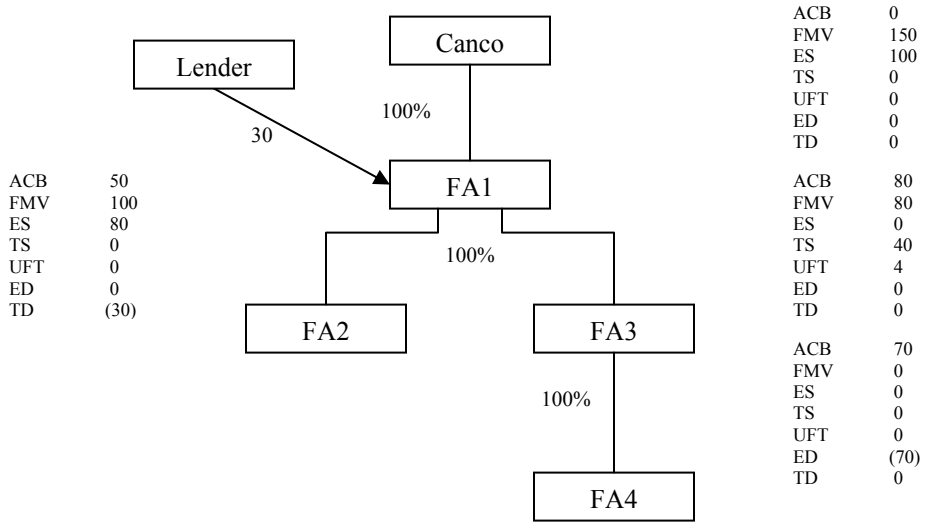
[18] This would also address a concern which has been raised relating to the permanent disappearance of surplus where excluded property is distributed to a non-resident shareholder in which the taxpayer has no direct or indirect equity interest, if the distribution occurs on a rollover basis.

Amount of Election – Proposed Regulation 5902(1)

Under the current rules, where subsection 93(1) applies in respect of the disposition of the shares of a particular affiliate, the surplus of the affiliate is determined by assuming that each other affiliate in which the particular affiliate had an equity percentage had paid dividends on its shares equal to its net surplus, seriatim beginning with the lowest-tier affiliate. Where the disposed affiliate is in a corporate chain including affiliates with deficit accounts (positioned above affiliates with surplus balances, such "blocking deficits" offset the surplus balances in the course of the hypothetical upwardly cascading distributions. However, where the corporate chain includes affiliates with deficit accounts positioned below or level with affiliates with positive surplus balances (what might be referred to as "dangling deficits"), the deficit accounts do not offset the surplus balances. In contrast, under the proposed amendments to Regulation 5902(1), surplus will be consolidated with deficits in all cases to produce "consolidated exempt surplus", "consolidated exempt deficit", "consolidated taxable surplus", "consolidated taxable deficit" and "consolidated net surplus".

More specifically, where a subsection 93(1) election is or is deemed to be made by a taxpayer, the amount prescribed, for purposes that subsection in respect of the disposed share is not to exceed the amount that would be received on that share immediately before the disposition if the disposed affiliate paid a dividend at that time on all of its shares, the total of which is equal to its consolidated net surplus in respect of the taxpayer immediately before the dividend time. The disposing affiliate's consolidated net surplus is defined to be the amount, if any, by which the total of the disposing affiliate's exempt and taxable surplus exceeds the total of the its exempt and taxable deficits, all computed in respect of the taxpayer. The disposing affiliate's consolidated exempt surplus is the total of its own exempt surplus and its proportionate share of the exempt surplus of each underlying affiliate in which it has a direct or indirect equity percentage. For this purpose, the exempt surplus of each affiliate is determined on the assumption that the affiliate had no exempt deficit, no taxable surplus and no taxable deficit. The affiliate's consolidated taxable surplus, consolidated exempt deficit, consolidated taxable deficit, and consolidated underlying foreign tax are similarly determined. For purposes of determining the portion of the whole dividend arising from the subsection 93(1) elected amount that is, for example, prescribed to be paid out of the disposing affiliate's exempt surplus, such exempt surplus is deemed to the amount, if any, by which the affiliate's consolidated exempt surplus exceeds its consolidated exempt deficit, and so on. Consider the following example:

Example A



Assumptions:

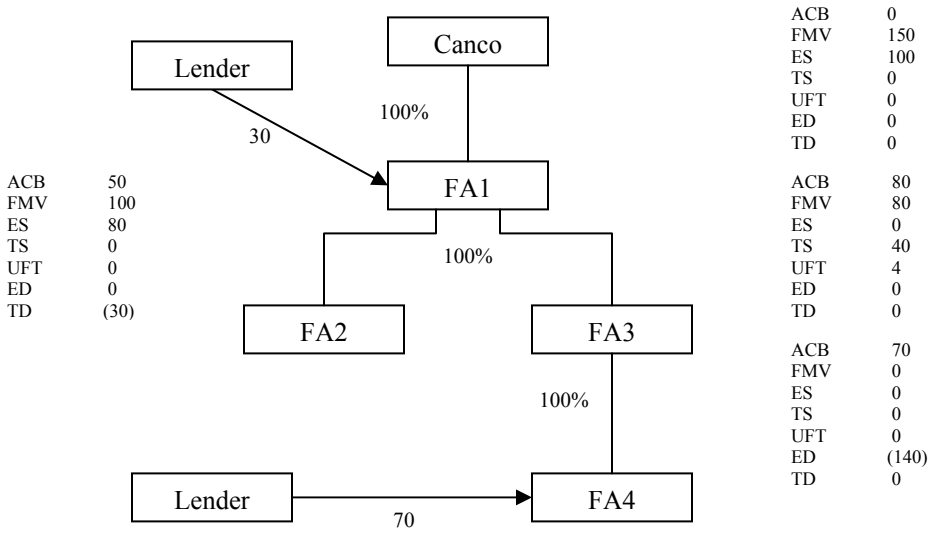
- Canco sells 100% of FA 1 (100 shares) to an unrelated non-affiliate for cash of $150.

Under the current rules, FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) ES of $150 (being its own ES of $100 and ES of $50 from FA2; (ii) TS of $40 from FA3; and (iii) UFT of $4, also from FA3. The ED of $140 in FA4 would be ignored, but the TD in FA2 would reduce its net surplus, and therefore its available exempt surplus. Under current Regulation 5902(1), Canco would presumably make a subsection 93(1) election of $150, all of which would be prescribed to be paid out of ES, and would have no resulting capital gain.

Under proposed Regulation 5902(1), FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) consolidated ES of $180 (being its own ES of $100 and ES of $80 from FA2); (ii) consolidated TS of $40 (from FA3); (iii) consolidated ED of $70 (from FA4); and (iv) consolidated TD of $30 (from FA2). FA1's consolidated net surplus would be $120 ($180 + $40 – $70 – $30), with the result that the amount of its "attributed net surplus" in respect of each disposed share (the "amount prescribed") would be $1.20. In total, the subsection 93(1) election would be limited to $120. For purposes of determining the surplus accounts out of which the deemed dividend would be prescribed to be paid, FA1 would be deemed to have ES of $110 ($180 - $70), TS of $10 ($40 - $30) and UFT of $4. Although all of the subsection 93(1) election amount of $120 would be fully deductible under subsection 113(1), the result under the proposed changes would be that Canco realizes a capital gain of $30.

Joint Committee's Comments

While the proposed amendments to Regulation 5902(1) may seem logical at a high level (for instance, in Example A, there is a $30 unrealized gain in the structure – in FA3 – and Canco realizes a capital gain of $30), they appear to suffer from at least one important flaw, namely the possibility of effectively attributing to a shareholder a portion of an affiliate's deficit which exceeds the shareholder's economic loss in respect of its investment in the affiliate. To illustrate this result, assume in Example A that FA4's deficit had been financed with $70 of borrowed capital from a 3rd Party lender. The facts would look as depicted below, the only differences being that FA4's ED is $140 rather than $70 and it has borrowed capital of $70:



In such a case, FA3's economic loss in respect of its investment in FA4 would still be $70 (like in Example A), but under the Legislative Proposals $140 of ED would be attributed. That is, under proposed Regulation 5902(1), FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) consolidated ES of $180 (being its own ES of $100 and ES of $80 from FA2); (ii) consolidated TS of $40 (from FA3); (iii) consolidated ED of $140 (from FA4); and (iv) consolidated TD of $30 (from FA2). FA1's consolidated net surplus would be $50 ($180 + $40 – $140 – $30), with the result that the amount of its "attributed net surplus" in respect of each disposed share (the "amount prescribed") would be $0.50. In total, the subsection 93(1) election would be limited to $50. For purposes of determining the surplus accounts out of which the deemed dividend would be prescribed to be paid, FA1 would be deemed to have ES of $40 ($180 - $140), TS of $10 ($40 - $30) and UFT of $4. Although all of the subsection 93(1) election amount of $50 would be fully deductible under subsection 113(1), the result under the proposed changes would be that Canco realizes a capital gain of $100. This result is inappropriate because there is still only a $30 unrealized gain in the structure – in FA3. Thus, Canco is being taxed on a "phantom gain" – that is, a gain that does not exist.

Viewed from a slightly different perspective, it is submitted that it would be inappropriate for more than $70 of FA4's deficit to be attributed to FA3, and then to FA1. However, the test under the Legislative Proposals is based on the amount that FA3 would receive from FA4 if FA4 paid a dividend equal to its "consolidated exempt deficit". The fact that this amount could exceed FA3's true economic loss does not enter into the equation. Thus, the proposed amendments over-attribute lower-tier deficits to higher-tier affiliates. Such untoward effects may, in appropriate cases, be avoidable[19] - but, arguably, should not arise in the first place. The structural flaw in this regard in the Legislative Proposals would appear to arise because of the fallacy that shareholders participate in profits to the same extent that they participate in losses. This is false in the case of shareholders of a limited liability company – indeed, that is the entire point of limited liability – to permit shareholders to participate in unlimited economic "upside" with limited exposure to economic "downside". Moreover, even if a shareholder has guaranteed the company's obligations, there is no structural need to attribute deficit on the shares in an amount exceeding the economic loss on the shares, since the shareholder should have a loss on the guarantee. Similarly, if deficit is attributed on the shares in an amount exceeding the economic loss on the shares because of a guarantee, such over-attribution should never exceed the amount guaranteed, and provision should be made to ensure that the shareholder's loss on the guarantee does not result in deficit duplication. Surely, we should be as concerned about deficit duplication as we are about surplus duplication – even-handedness.

Other aspects of this approach also seem to be capable of producing inappropriate results. To illustrate, in Example A, while it is clear that there has been a loss of $70 (the $70 that was invested in FA4), it is not clear that this loss ought to be considered to have eroded any of the exempt surplus in the chain – that would be the case to the extent that the $70 investment in FA4 was funded with a reinvestment of ES earned by FA3, but not the case to the extent that the $70 investment in FA4 was funded with a reinvestment of TS earned by FA3. In Example A, the proposed amendments would seem to allocate the $70 loss against ES as to $40 (reducing the ES dividend from $150 to $110), and against TS as to $30 (reducing TS from $40 to $10). These are not necessarily the appropriate amounts**.**

These flaws are inherent in the structural mechanics of determining consolidated net surplus, which includes all deficits within the group of relevant affiliates regardless of where in the group the deficits are located or how they are financed. The result is different than the result that would be obtained if dividends where paid up the chain of affiliates. In this respect, the proposed amendments represent a fundamental change to what subsection 93(1) was originally enacted to accomplish, which was to be a proxy for an actual dividend that could be paid up the chain (in Example A, from FA2, FA3 and FA4 to FA1 and then to Canco). As is evident from Example A, that may no longer be the case. Canco could eliminate the capital gain of $30 that would otherwise arise as a result of the proposed amendments if immediately prior to the sale of

[19] For example, it may be possible in certain circumstances to avoid such over-attribution of "dangling deficits" by first selling affiliates that have deficits exceeding the relevant economic loss.

the FA1 shares, FA2 paid a dividend to FA1 from exempt surplus of $50 followed by a dividend of $150 from FA1 to Canco. This would presumably reduce Canco's proceeds on the sale of the FA1 shares and the capital gain. No Canadian tax would therefore be exigible, which is the result under the current rules, but the dividends from FA2 and FA1 could potentially be subject to foreign withholding tax. In this sense, this proposal would seem to put Canadian multinationals and the Canadian economy in a disadvantageous position, in that it would create an incentive to incur foreign withholding tax to the extent that the amount of such tax would be lower than the Canadian capital gains tax that would be payable if no dividend were paid. Surely, it cannot be in the interests of Canadians to create incentives for Canadian multinationals to incur foreign withholding tax costs – and this is the very foundation of subsection 93(1).

Applicability of a subsection 93(1) election

Subsection 93(1.4)

Pursuant to proposed subsection 93(1.4), no election can or will be deemed to be made under subsection 93(1) or (1.2) by a corporation in respect of the disposition of a share of a foreign affiliate if any of the specified provisions referred to in that subsection applies to the disposition. These are: paragraph 88(3)(a) and subparagraphs 95(2)(d)(i), (d.1)(i), (e)(i), (e.1)(i), (e.2)(i),[20] (e.3)(i), (e.4)(i) and (e.5)(i) (these subparagraphs are discussed above and in the Appendix hereto). Interestingly, neither paragraph 95(2)(c) nor proposed paragraph 95(2)(c.2) is mentioned (these paragraphs are also discussed above and in the Appendix hereto).

The purpose of subsection 93(1.4) seems to be to permit the subsection 93(1) election in respect of dispositions at the shareholder level (indeed, to require it where subsection 93(1.1) applies – where the disposition is by a foreign affiliate of a corporation), but not at the level of corporate assets disposed of in the context of a foreign merger, liquidation or distribution.[21]

Subsection 93(1.1)

The Legislative Proposals expand subsection 93(1.1) such that it will apply whenever shares of a foreign affiliate of a corporation resident in Canada are disposed of by another foreign affiliate of the corporation, whether or not the shares constitute excluded property. The proposed amendment would also eliminate the exclusion from subsection 93(1.1) in respect of dispositions to which any of paragraphs 95(2)(c), (d) or (e) applies. It would render subsection 93(1) applicable in <u>all cases</u> where a share of a foreign affiliate of a corporation is disposed of by another affiliate, subject to the limitations in proposed subsection 93(1.4) noted above.

Joint Committee's Comments

[20] The reference to proposed subparagraph 95(2)(e.2)(i) would seem to be inadvertent.

[21] An exception is proposed paragraph 88(3)(a), which we understand is a drafting error.

Subsection 93(1.1) has been expanded to apply in every case where there is a disposition of shares of a foreign affiliate held by another affiliate. This provision was intended to prevent taxpayers from converting undistributed taxable surplus into capital gains, with consequent surplus apportionment. If it is appropriate in policy terms to extend the application of this rule, on the basis that underlying surplus should always be apportioned to the same account at the shareholder affiliate level, then it seems difficult to understand why that would not be true in all cases. We are not clear on why subsection 93(1.4) is necessary or what purpose it serves.

The restrictions in subsection 93(1.4) on the application of subsection 93(1) seem to relate to assets of a merging, liquidating, distributing affiliate. We are not clear on why this is necessary. What if the property being distributed is shares of another FA, and there is no disposition of the shares of the distributing affiliate on that distribution? Moreover, even where the distribution results in a disposition of the shares of the distributing affiliate, it seems inappropriate to preclude a subsection 93(1) deemed dividend with respect to distributed property – i.e., shares of another affiliate, since those shares will not be owned by the distributing affiliate at the time of the disposition of the shares of the distributing affiliate, such that the underlying surplus will be completely unavailable.

It is submitted that proposed subsection 93(1.4) should be withdrawn.

Post-Election Adjustments – Proposed Regulations 5902(3) and 5905(2), (4), (5) and (8)

Apart from an additional reference to Regulation 5902(4), Regulation 5902(3) is essentially unchanged, and therefore continues to preclude an adjustment to surplus in respect of a subsection 93(1) deemed dividend, except as provided in Regulations 5905(2), (4), (5) and (8).[22] These latter provisions govern adjustments to be made in respect of certain redemptions, cancellations or acquisitions of foreign affiliate shares, certain foreign mergers involving affiliates, certain Canadian transactions involving interests in foreign affiliates, and certain other dispositions to other foreign affiliates or related persons. The revisions to each of these provisions are substantially similar, and are discussed immediately below in the context of Regulation 5905(8) – sale of shares of a foreign affiliate to another foreign affiliate.

Current Approach

Under the current rules, where a subsection 93(1) deemed dividend arises in respect of a relevant sale of shares, Regulation 5905(8) makes corresponding adjustments to the surplus accounts of the affiliate whose shares were disposed of, which could result in such accounts becoming a deficit, but no adjustments are made to the accounts of any lower-tier affiliates, even though the amount of the deemed dividend would reflect the attribution of their exempt and taxable surplus. This is not an illogical approach, and in fact has operated relatively well over a number of decades. It is appropriate for no adjustment to be made to the accounts of lower-tier

[22] The reference to Regulation 5905(5) should probably be a reference to Regulation 5905(6).

affiliates because the value which corresponds to the lower-tier surplus taken into account at the top tier has not in fact been extracted, and remains within the lower-tier affiliates. That lower-tier surplus will also be required in the future in order to in fact distribute that value without eroding the ACB of the shares of the relevant lower-tier affiliates.

However, it is understood that the Department of Finance had perceived concerns with respect to this "separation" of surplus and corresponding deficit, and accordingly is proposing to introduce a more comprehensive and complex "balance adjustment" mechanism under revised Regulation 5905, which would produce adjustments at all relevant tiers.

Proposed Approach

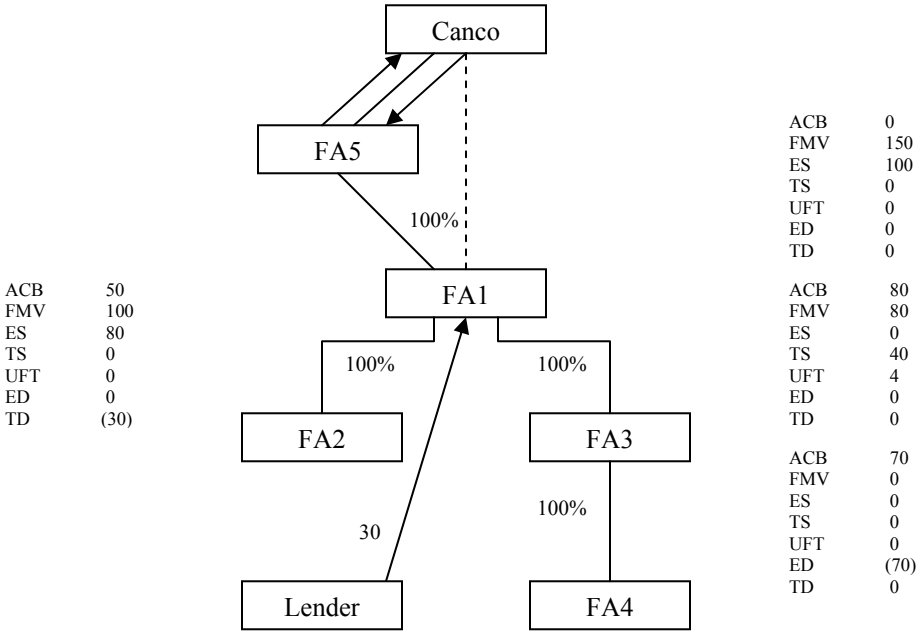
Proposed regulation 5905(8)(a) will essentially require the exempt surplus portion of the 93(1) elected dividend amount to be allocated (through an "exempt surplus reduction" amount) proportionately to, and reduce the ES of, each foreign affiliate in the relevant chain that had a balance of exempt surplus at the dividend time. The proportionate amount for a particular affiliate is determined by the formula A/B, where A is the particular affiliate's ES that can reasonably be considered to have been included in the consolidated ES of the affiliate whose shares were disposed of (such affiliate is referred to as the "issuing affiliate"), and B is the issuing affiliate's consolidated ES.[23] Proposed regulation 5905(8)(a) will require the taxable surplus portion of the elected amount to be allocated (through a "taxable surplus reduction" amount) proportionately to each foreign affiliate in the relevant chain that had a balance of taxable surplus in a manner similar to the ES allocation.

When a subsection 93(1) election is made on the internal sale of a FA share, Regulation 5905(8)(a) will reduce the exempt and taxable deficit of an affiliate in the chain to *nil*, and will require a corresponding proportionate reduction in the exempt and/or taxable surplus balances for those affiliates in the chain that have exempt and/or taxable surplus balances. If the issuing affiliate had consolidated ES in excess of its consolidated ED, the exempt deficits that are eliminated will be allocated (through "exempt deficit reduction" amounts) proportionately to those affiliates that had a balance of ES. If the issuing affiliate had, for example, consolidate ED in excess of its consolidated ES, each affiliate that had a balance of ES will have that balance reduced to *nil* (through the "exempt deficit reduction" amounts), and the excess of the issuing affiliate's consolidated ED over its consolidated ES will be allocated (through "exempt deficit

[23] The proportionate amount so determined is then adjusted for a specified adjustment factor for the particular affiliate. This factor is determined by the formula X/Y, where X is (a) where Canco disposed of the shares, 100%, and (b) when another affiliate disposed of the shares, the surplus entitlement percentage ("SEP") of Canco in that other affiliate immediately before the disposition; and Y is Canco's SEP in the particular affiliate immediately before the disposition.

allocation" amounts) proportionately to those affiliates that had a balance of TS. Similar rules apply to the allocation of TDs that are reduced to *nil*.[24]

Example B



Assumptions:

- Canco sells 100% of FA 1 (100 shares) to FA5 for cash of $120 and shares of FA5, and Canco makes subsection 93(1) election for $120.

As noted in Example A, for purposes of subsection 93(1) under current rules, FA1 would be deemed to have ES of $150, TS of $40 and UFT of $4. A subsection 93(1) election of $120 would result in a dividend prescribed to be paid solely out of ES, and FA1's $100 of ES would become an exempt deficit of $20, and no adjustment would be made to the surplus accounts of FA2, FA3 or FA4. Thus, on a "consolidated basis", the FA1/FA2/FA3 group would have (net) ES of only $30 and (net) TS of $40, which would be appropriate. The fact that FA2 would still have $50 of (net) ES would also be appropriate, because FA2 would still have the value corresponding to that ES, and would need that ES in order to be able to pay a dividend to FA1 equal to $50 without eroding FA1's ACB in FA2. Once that dividend is paid, the $20 blocking deficit in FA1 would result in FA1 having ES of $30, which again is appropriate. In a similar

[24] If the issuing FA had consolidated TD in excess of consolidated TS, the excess would be proportionately allocated to, and reduce, the other affiliates' ES through the "taxable deficit allocation" amounts.

vein, when FA3 pays a $40 TS dividend to FA1, it will result in FA1 having ES of $30 and TS of $40 (as well as UFT of $4), which again is appropriate

As indicated in Example B, under the proposed rules, the subsection 93(1) elected dividend amount of $120 would be prescribed to be a $110 ES dividend and a $10 TS dividend, and the following adjustments would be made:

- The $110 ES portion would be allocated proportionately between FA1 and FA2. FA1's consolidated ES is $180 and consists of FA1's ES of $100 and FA2's ES of $80. FA1's proportions of the consolidated ES is 55% (100/180) and FA2's proportion is 45% (80/180). The $110 ES dividend amount would be allocated $61 to FA1 and $49 to FA2, and reduces the ES of these affiliates accordingly (these reductions are the "exempt surplus reduction" amounts).

- The TS portion ($10) of Canco's subsection 93(1) elected amount ($120) would be allocated solely to FA3, and would be the "taxable surplus reduction" amount for FA3.

- The $70 ED of FA4 would be reduced to *nil*.

- Since FA1 had a "consolidated exempt deficit" of $70, and had consolidated ES in excess of this amount, this deficit is "allocated" proportionately to FA1 and FA2 (55%, or $39, to FA1, and 45%, or $31, to FA2), and these amounts are the "exempt deficit reduction" amounts to FA1 and FA2.

- Similarly, the $30 TD of FA2 would be reduced to *nil*, and since the consolidated TS of FA1 exceeds its consolidated TD, FA2's TD of $30 would be allocated to FA3 through the "taxable deficit reduction" amount.

- In summary, FA1's ES of $100 would be reduced to *nil* (by the $61 exempt surplus reduction amount and the $39 exempt deficit reduction amount. FA2's ES of $80 would be reduced to *nil* (through the $49 exempt surplus reduction amount and the $31 exempt deficit reduction amount). FA3's TS of $40 would be reduced to *nil* (through the $10 taxable surplus reduction amount and the $30 taxable deficit reduction amount). FA2's TD of $30 and FA4's ED of $140 would also be reduced to *nil.*

Joint Committee's Comments

As noted, we understand that the proposals described above are intended to mitigate possible abuses of the current rules where, as a result of a 93(1) election, a deficit is created within a group of affiliates that is subsequently avoided or eliminated resulting in the effective duplication of, in particular, exempt surplus.

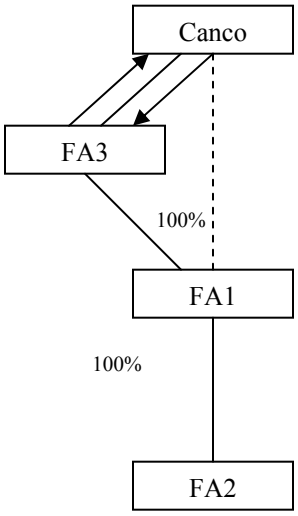
The Committee submits that these perceived concerns would largely be addressed by the proposed revisions to Regulation 5905(7) concerning the elimination of blocking deficits on the

liquidation of an affiliate, and that the addition of these added measures will introduce a significant degree of unnecessary complexity into the foreign affiliate rules, and unnecessarily increase the compliance burden on taxpayers, as well as the administrative burden on the Crown. Further, these proposals, and those discussed below, include a number of significant structural and technical deficiencies.

As a result of these proposals, a subsection 93(1) election could change the make-up of the surplus accounts within a particular group of affiliates in ways that, unlike under the current system, may not be particularly intuitive, or particularly appropriate. In Example B, Canco extracted $120 of cash from FA5 free of Canadian tax, but the subsection 93(1) election of $120 reduced all surplus and deficit accounts of the relevant affiliates to *nil*. If Canco had transferred the FA1 shares to FA5 solely for shares, Canco could have subsequently extracted, free of Canadian tax, $150 of cash from FA5 through the actual payment of ES dividends ($50 from FA2; $100 from FA1). Moreover, in Example B, if Canco had only transferred one FA1 share to FA5 for cash of $1.20, and Canco made a subsection 93(1) election for the $1.20, the ES reduction amount for FA1 and FA2 would only aggregate $1.10, but the ED reduction amount to FA1 and FA2 would still be the $70 amount noted above. As a result of a subsection 93(1) election of $1.20, for subsequent dividend purposes the combined ES of FA1 and FA2 would be reduced to $108.90. It is submitted that this result is completely inappropriate, and is an example of the structural deficiencies inherent in these proposals.

It should be noted also that there may be circumstances in which the proposed amendments would give rise to planning opportunities in this regard. Consider the following example.

Example C



	Before	After
ACB	100	101
FMV	101	101
ES	0	0
TS	50	0
UFT	0	0
ED	0	0
TD	0	0

ACB	50	1
FMV	1	1
ES	0	0
TS	0	0
UFT	0	0
ED	(49)	0
TD	0	0

Assumptions:

- Canco transfers FA1 to FA3 for $101 cash, and Canco makes a subsection 93(1) election for $1 (deemed to be a TS dividend).

Under proposed regulation 5905(8)(a), FA2's ED of $49 would be reduced to *nil*, and would be applied against FA1's TS. If FA2 subsequently became profitable, ES dividends could immediately begin being paid out through FA2 and FA1. In contrast, if this "balance adjustment" transaction were not carried out, FA2 would have to first accumulate exempt earnings equal to its ED before any ES dividends could be paid by FA2.[25] Again, the structural aspects of these proposals give rise to results that would seem to be inappropriate.

Finally and perhaps most important, these proposed changes are exceedingly complex and are virtually impossible for taxpayers to understand. The complexity starts with the Department's proposal requiring the computation of consolidated net surplus for the relevant group and then requiring the surplus and deficit balances for each member of the group to be adjusted.[26] We refer to the presentation at the conference hosted by the Canadian Branch of the International Fiscal Association on May 10, 2004, during which the Department provided an example of the computation of consolidated net surplus and the adjustments that would need to be made to the surplus accounts of foreign affiliates in a hypothetical transaction. We refer also

[25] It should be noted also that there would be a downward adjustment to FA1's ACB in FA2 (for certain purposes), equal to the amount by which FA2's deficit has been reduced, in accordance with the rules in proposed subsections 92(1.1) to (1.4) and Regulation 5911. See the discussion below.

[26] A further complication, as discussed below, there is also a requirement to adjust the ACB of the shares of the affiliates in the group.

to the examples considered above. We submit that there would be few, if any, taxpayers, that would have been able to prepare such calculations in advance of such a transaction in actual practice, and therefore few, if any, that would have been able to understand or predict the effects that the 93(1) election would have on their affiliates' surplus accounts.

The uncertainty created by the proposed amendments in this regard arises not only because of the complexity of the provisions, but also because of structural aspects of the proposals. That is, because a subsection 93(1) election would require adjustments to be made in respect of the accounts of all relevant affiliates, not just the issuing affiliate, uncertainty or error with respect to the accounts of a single affiliate will have a cascading effect and could result in uncertainty and error throughout the entire group. This could result in significant problems in the context of a foreign affiliate reorganization in actual practice, and thereby compromise the competitiveness of Canadian multinationals.

Accordingly, it is our submission that this proposed measure be withdrawn. To be clear, it is not our submission that Regulation 5905 should not be updated, or that the various technical issues that exist in that regard should be ignored. For example, there does not appear to be any rule currently in Regulation 5905 that would account for a subsection 93(1) election made in the context of a foreign merger, with the result that surplus can be duplicated in that context. Moreover, there are significant issues relating to the determination of a taxpayer's surplus entitlement percentage under Regulation 5905. There is also no rule that would preserve a deficit in the context of a liquidation of one foreign affiliate into another. These and similar issues should be addressed, but it does not follow that the fundamental architecture of the regime reflected in this regulation should be reoriented.

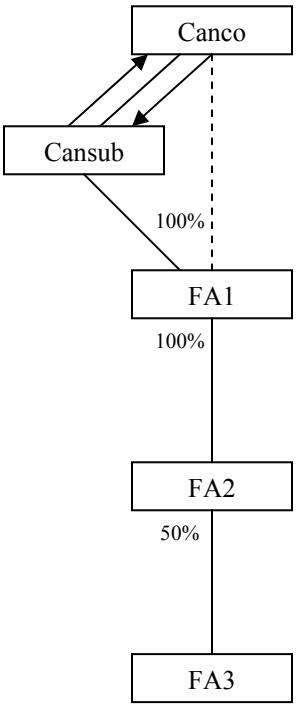
Parallel Regimes – Proposed Regulations 5905(2),(4), and (6)

Parallel regimes would be introduced with respect to subsection 93(1) deemed dividends arising in the context of share redemptions (governed by Regulation 5905(2)) and foreign mergers (governed by Regulations 5905(3) and (4)), and in the context of a disposition by a corporation resident in Canada to a related taxable Canadian corporation (governed by R. 5905(5)(a) and (6)).

With respect to adjustments required for a subsection 93(1) deemed dividend arising on a Regulation 5905(5)(a) transaction (i.e. a sale of shares of a foreign affiliate by a corporation resident in Canada to a non-arms length taxable Canadian corporation), a different approach is proposed in Regulation 5905(6)(a). In particular, the reduction to the exempt and/or taxable surplus of each relevant foreign affiliate to reflect the exempt and/or taxable surplus portion(s) of the subsection 93(1) deemed dividend is not referenced to "exempt surplus reduction" or "taxable surplus reduction" amounts, but rather these reduction amounts are set out in regulation 5905(6)(a). Each of these amounts is computed in a manner similar to the exempt surplus and taxable surplus a reduction amounts.

There also appears to be a deficiency in Regulation 5905(6)(a) with respect to the allocation of relevant affiliates' exempt/taxable deficits. With respect to the allocation of exempt deficits, for example, rather than having both an "exempt deficit reduction" amount and a "taxable deficit allocation" amount, Regulation 5905(6)(a) provides for a "taxable deficit allocation" amount, but also provides for what would otherwise be the "exempt deficit reduction" amount only in a situation where the issuing foreign affiliate has a net consolidated exempt deficit amount.[27]

Example D



	Before	After
ACB	0	250
FMV	250	250
ES	300	86 [-214]
TS	0	0
UFT	0	0
ED	0	0
TD	0	0

ACB	300	250
FMV	250	250
ES	0	0
TS	0	0
UFT	0	0
ED	(100)	0
TD	0	0

ACB	100	150
FMV	150	150
ES	100*	29 [-71]
TS	0	0
UFT	0	0
ED	0	0
TD	0	0

* 100 x 50% = 50

Assumptions:

- Canco sells FA1 to Cansub for cash of $250, and makes a subsection 93(1) election for $250 ($2.50 per share) (all deemed to be an ES dividend).

In Example D, FA1 would be deemed to have consolidated exempt surplus of $350, consolidated exempt deficit of $100, and consolidated net surplus of $250. Under proposed Regulation 5905(6)(a)(i)(A), the ES of both FA1 and FA3 would be reduced proportionately to reflect the ES portion ($250) of the subsection 93(1) elected amount. This reduction for FA1 would be $214 (being 300/350 x 250/100%) and for FA3 would be $71 (being 100/350 x 250/.5). Since

[27] In such a situation, the grind to a particular affiliate's ES is the ES amount.

FA1's consolidated exempt deficit is less than its consolidated exempt surplus, there is no amount determined under proposed Regulation 5905(6)(a)(i)(C). There is also no amount determined under proposed Regulation 5905(6)(a)(i)(D) and Regulation 5905(19), since there is no consolidated taxable deficit. Under proposed Regulation 5905(6)(a)(iv), the ED of FA2 would be reduced to *nil*.

After the Regulation 5905(6)(a) adjustments, the ES of FA1 would be reduced to $86, the ED of FA2 would be reduced to *nil*, and the ES of FA3 would be reduced to $29. Since Canco made a subsection 93(1) election equal to the consolidated net surplus ($250), there should be no ES left in the group. We would expect that Regulation 5905(6)(a)(i)(C) should be modified so that the amount determined in Regulation 5905(6)(a)(i)(C) will be the "exempt deficit reduction" amount as determined under Regulation 5905(17).

Our comments above with respect to the complexity and the compliance burden imposed on taxpayers are relevant here as well.

Basis Adjustments – Proposed Subsections 92(1.1) to (1.4)

In recognition of the fact that decreasing an affiliate's surplus would result in an erosion of the ACB of its shares on a subsequent distribution of the value reflected by that surplus, and in recognition of the fact that deficit duplication could arise as a result of upward deficit attribution because of an inherent loss in the relevant shares, proposed subsections 92(1.1) to (1.4) would introduce a regime that would adjust the ACB of the shares of a particular relevant foreign affiliate (other than the disposed affiliate) to reflect adjustments to its accounts arising because of a subsection 93(1) election. However, these adjustments would only apply (i) to some extent, (ii) only for certain purposes, and (iii) only in respect of shares that are excluded property at the relevant times.

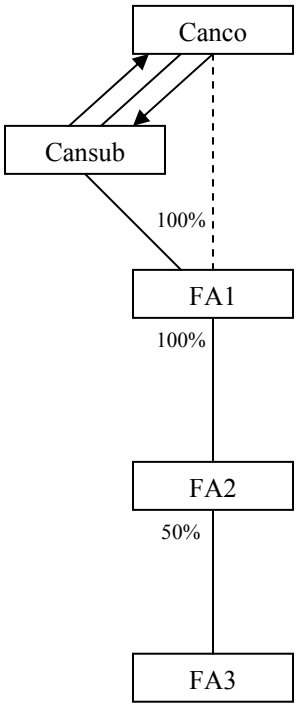
Pursuant to proposed Regulation 5911(1), the amount of the relevant increase to ACB would be the lesser of two amounts. The first would be the amount, if any, by which the FMV of the relevant shares (at the election time) exceeds their ACB. The second amount would be the amount generally determined under Regulation 5911(1)(b), which is the amount (on a per share basis) that the particular affiliate's consolidated net surplus would have been reduced by the Regulation 5905 adjustments if the particular affiliate had been the disposed affiliate.

Similarly, proposed Regulation 5911(2) would prescribe the amount by which the ACB of the shares of a particular relevant foreign affiliate would be reduced to account for the attribution of its deficits. Again, however, this adjustment is the lesser of two amounts. The first is the amount, if any, by which the ACB of the relevant shares exceeds their FMV. The second

amount, determined under Regulation 5911(2)(b), would be the amount (on a per share basis) of the particular affiliate's consolidated net deficit.[28]

In addition, where the relevant share does not have any attributable "consolidated net surplus" or "consolidated net deficit", and therefore no adjustment would be made under proposed Regulation 5911(1) or (2), it appears to be intended that there be an adjustment pursuant to proposed Regulation 5911(3), increasing the ACB of the relevant share by the lesser of any difference between its FMV and its ACB and the amount of any "consolidated net surplus" remaining in the relevant affiliate after the first order adjustments are made as a result of the subsection 93(1) election. The effect and implications of this provision are not clear.

Example E (same as Example D)



	Before	After
ACB	0	250
FMV	250	250
ES	300	86 [-214]
TS	0	0
UFT	0	0
ED	0	0
TD	0	0

ACB	300	250
FMV	250	250
ES	0	0
TS	0	0
UFT	0	0
ED	(100)	0
TD	0	0

ACB	100	150
FMV	150	150
ES	100*	29 [-71]
TS	0	0
UFT	0	0
ED	0	0
TD	0	0

* 100 x 50% = 50

Assumptions:

- Canco sells FA1 to Cansub for cash of $250, and makes a subsection 93(1) election for $250 ($2.50 per share) (all deemed to be an ES dividend).

[28] This is not actually an expression defined or used in the proposed amendments, but has been adopted by the authors to refer to the amount by which the total of the relevant affiliate's "consolidated exempt deficit" and its "consolidated taxable deficit" exceeds the total of its "consolidated exempt surplus" and its "consolidated taxable surplus".

Proposed Regulation 5911(1) would prescribe $0.50 as the amount the ACB of each share of FA3 should be increased under paragraph 92(1.3)(a) (for certain purposes), being the lesser of two amounts, namely

(a) the amount of which the FMV of the share exceeds its ACB ($0.50); and
(b) the amount(s) by which the consolidated net surplus would have been reduced under Regulation 5905 had the FA3 share been the disposed share (i.e., $0.71, being A/C x (C – B) = 1.00/100 x (100 – 29)).[29]

With respect to each share of FA2, the amount determined under Regulation 5911(2)(b) would be *nil*, being A/C x (C – B), where A = 0, B = 0 and C = 100. It would appear that the amount under Regulation 5911(1)(b) would also be *nil*, being A/C x (C – B) = 0/0 x (0 – 0).

However, Regulation 5911(3)(b) would not appear to have application for FA2, since the amount determined in both 5911(1)(b) and 5911(2)(b) for FA2 is *nil*, and the amount determined for B in the formula in 5911(1)(b), and for C in the formula in 5911(2)(b), is also *nil*. In any event, the amount determined under Regulation 5911(3) for FA2 would, in this Example, be *nil*, since the FMV of the FA2 shares does not exceed their ACB.

Joint Committee's Comments

The Committee agrees that, conceptually, if the surplus or deficit of an affiliate is adjusted in accordance with the proposed changes to Regulation 5905 discussed above as a result of a 93(1) election, it is appropriate and necessary to adjust the ACB of the shares of the affiliate. However, the purpose, effect and other implications of these provisions are unclear in various respects. The Committee submits that this is, once again, the result of the exceedingly complex nature of the Department's proposals requiring the computation consolidated net surplus and adjusting surplus/deficit balances as a result of a 93(1) election. For example, it is not clear why the "purposes" mentioned in proposed subsection 92(1.4) would not make any reference to the computation of FAPI. The Committee submits these basis adjustments should be made for all purposes of the foreign affiliate rules in the Act and the Regulations, and whether the relevant shares are excluded property, to minimize inordinate tax attribute erosion or deficit duplication.

In addition, it is not clear why the adjustment to ACB of the relevant share, pursuant to Regulation 5911, is restricted in paragraph 92(1.3)(a) to the excess of FMV over ACB and in paragraph 92(1.3)(b) to the excess of ACB over FMV, and not the full amount of the adjustment to the affiliate's surplus/deficit, as the case may be. These provisions seem to assume that the FMV of the shares of a FA will be less than ACB if the FA has a deficit and that the FMV of the shares will be greater than ACB if it has a surplus balance. This is not necessarily the case.

[29] The Committee submits that the reference in Description B in 5911(1)(b) should be to 5902(1)(e)(vi).

Surplus/deficits could be positively/adversely affected by various timing differences and unrealized gains and losses.

More importantly, the logic reflected in this particular proposal demonstrates that the logic reflected in the proposed corresponding amendments to Regulation 5905 is backwards, in that the amount of the adjustment to the affiliates surplus/deficit should be limited in the first place to the excess of FMV over ACB (in the case of a deficit push-down), and to the excess of ACB over FMV (in the case of a deficit pull-up).[30] As noted above, deficit should never be attributed upwards in an amount exceeding the shareholder's economic loss on the shares. If upward deficit attribution was limited in this manner, then it would make sense and it would be consistent to limit basis adjustments in the same manner – to the difference between ACB and FMV – but such a limitation to basis adjustments is not appropriate if there is no corresponding limitation to surplus and deficit adjustments.

Finally, we would emphasize that the substitution of ACB adjustments for surplus or deficit attributes would not necessarily be appropriate, and would reflect yet another departure from the existing architecture of the system. That is, surplus and deficit attributes are accounted for in the relevant affiliate's calculating currency, but the ACB of its shares would be calculated either in Canadian Dollars or in the shareholder's calculating currency. Thus, if we assume that a particular affiliate has ES of $100 US Dollars, and the ACB of its shares is *nil*, and then its ES is reduced to *nil* and the ACB of its shares is increased by $100 US Dollars – or, rather, by the Canadian Dollar or other calculating currency equivalent of $100 US Dollars at that time – then the amount of value that could subsequently be extracted from that affiliate without any gain or loss at the shareholder level would be the Canadian Dollar or other calculating currency equivalent of $100 US Dollars at that time – that is, the adjustment time, not the subsequent distribution time. Accordingly, if the value of the affiliate's calculating currency (the US Dollar, in our example) increases relative to the Canadian Dollar or its shareholder's calculating currency, then there would be a gain upon the extraction of the original surplus (i.e., the $100 US Dollars). Conversely, if the value of the affiliate's calculating currency (the US Dollar) decreases relative to the Canadian Dollar or its shareholder's calculating currency, then there would be a loss upon the extraction of the original surplus (i.e., the $100 US Dollars). Neither result is appropriate, which explains why the current architecture of the system is configured as it is, and why it should not be reconfigured.

Summary: Joint Committee's Comments on Surplus Adjustments and 93(1) Elections

The Committee respectfully submits that even if it is assumed that the proposed changes with respect to surplus adjustments and subsection 93(1) would improve the current system (and, based on the technical and structural deficiencies noted above, this is far from being the case), it

[30] See Joint Committee's Comments above under *Amount of Election – Proposed Regulation 5902(1)*

must be acknowledged that the price would be a significant increase in the complexity of the foreign affiliate system and in the compliance burden on taxpayers to maintain accurate and up-to-date surplus balances and ACB balances and to make adjustments thereto. In addition, it must be acknowledged that many of the proposed changes go to the very foundation of the system's architecture, and would in many cases give rise to results that are inappropriate.

The surplus balances of any foreign affiliate are difficult to know with any degree certainty at any particular moment in time. Therefore, a transaction that requires knowledge of the surplus balances at the time the transaction is carried out will create greater uncertainty. Even if the relevant foreign tax returns are complete and the surplus balances are computed on the basis of those returns, they are still subject to change as a result of regular day-to-day surplus maintenance. For example, final foreign audit adjustments may only be made years after the taxation year(s) in question ended. Furthermore, surplus balances are open for audit by CRA for all years back to 1972. These issues make it very difficult for a taxpayer to be compliant even before attempting to assess the ability to comply with the 93(1) proposals.

The proposals elevate the importance of the surplus balances of each affiliate, by

- making more affiliates relevant under the consolidated net surplus approach for the purposes of a subsection 93(1) election,
- requiring adjustments to the surplus or deficit balances of each of those affiliates, and
- making the ACB adjustments dependent upon the surplus balances.

However, as indicated above, for various reasons these surplus balances are continually subject to change. By increasing the timely importance of an amount (i.e., a surplus balance), which is already uncertain, the proposals create a system where taxpayers will have to make tax-related decisions despite the inability to know the Canadian income tax results of a particular transaction. In effect, taxpayers are being forced to know the exact surplus balances of their various affiliates regardless of the inherent limitations that prevent such perfect surplus knowledge. As a result, the Committee firmly believes that it will be virtually impossible for many taxpayers to be compliant, not because of unwillingness on their part, but rather because of the inability to cope with (i) the real time certainty of the surplus/deficit balances and ACB calculations that these proposals inherently demand and (ii) the complexity inherent in the relevant provisions that require adjustments to the surplus/deficit balances and the ACB calculations.

In summary, while the Committee acknowledges the Department's concerns with possible abuses under the current 93(1) rules, the proposed approaches contain various technical and structural deficiencies that do not enhance – and, in many cases, compromise – the integrity of the foreign affiliate system. Further, the deficiencies in the current system do not warrant the level of complexity and compliance burden that these proposals would impose. The Committee

strongly recommends that this proposal to net surplus and deficit accounts at different tiers (and in different currencies) and to substitute ACB adjustments for those attributes should be withdrawn. At a minimum, it is our recommendation that any change to the rules for determining the amount or consequences of a 93(1) election should not result in a burden for taxpayers that will make it nearly impossible for most to understand, let alone comply with the rules. Furthermore, any such changes should not create a bias in favour of paying actual dividends, and a corresponding incentive to incur foreign withholding tax, and should not result in deficit over-attribution, or inadequate ACB adjustments giving rise to potential deficit duplication.

Proposed Regulation 5905(7)

Under current rules, a liquidation of a foreign affiliate results in the elimination of any deficit which it may have had, since the liquidating affiliate is merely deemed to pay a dividend equal to its adjusted net surplus for these purposes. However, proposed Regulations 5905(7) to (7.4) would introduce a regime that would provide for continuity in respect of deficits (and surplus) where a particular affiliate is liquidated into another affiliate.

Surplus Continuity

Once again, a distinction would be drawn between the circumstances in which proposed paragraph 95(2)(e) applies, and those in which proposed paragraph 95(2)(e.1) applies. Where proposed paragraph 95(2)(e.1) applies, each affiliate of the relevant corporation that had a direct equity percentage in the liquidating affiliate would be deemed, pursuant to proposed Regulation 5905(7)(a), to have received dividends from the liquidating affiliate equal to its proportionate share of the liquidating affiliate's net surplus. However, where proposed paragraph 95(2)(e) applies, there would be no such automatic surplus continuity.

Deficits

Surprisingly, deficit continuity would be provided for even if proposed paragraph 95(2)(e) would apply to the liquidation.[31] Pursuant to proposed Regulation 5905(7)(d), the ES of each higher-tier affiliate would be deemed to be decreased by its proportionate share of any ED of the liquidating affiliate and, to the extent that such proportionate share of ED exceeds that ES, the balance would serve to increase the higher-tier affiliate's ED in accordance with proposed Regulation 5905(7)(b). Similarly, pursuant to proposed Regulation 5905(7)(e), the TS of each higher-tier affiliate would be deemed to be decreased by its proportionate share of any TD of the liquidating affiliate and, to the extent that such proportionate share of TD exceeds that TS, the

[31] Very surprisingly, the application date for the deficit continuity in a paragraph 95(2)(e) liquidation and dissolution is dissolutions that occur after December 22, 2002 even though there was no mention in the December 22, 2002 proposals that this amendment would apply in a paragraph 95(2)(e) context.

balance would serve to increase the higher-tier affiliate's TD in accordance with proposed Regulation 5905(7)(c).[32]

These rules could result in effective deficit duplication where the shareholder affiliate realizes a loss as a result of the disposition, and is required to pick up a portion of the liquidating affiliate's deficit, where the loss and the deficit reflect the same underlying economic loss. The liquidation would not result in a loss on the shares of the liquidating affiliate if proposed paragraph 95(2)(e.1) were applicable. However, if proposed paragraph 95(2)(e) were applicable, a loss could result from the disposition of the shares of the liquidating affiliate. If, in addition, the higher-tier affiliate is required to pick up its share of the liquidating affiliate's deficit, then duplication will arise. Moreover, in either context, it would appear that duplication could arise where the higher-tier affiliate has capitalized the liquidating affiliate with debt rather than equity, to the extent that a loss from the disposition of the debt is realized by the higher-tier affiliate and that debt has financed the underlying deficit.

In brief, while the Committee acknowledges (as noted above) that there should be some mechanism to preserve deficits on the liquidation of an affiliate, we would strongly recommend that any changes in this regard be made in a manner that does not result in deficit over-attribution or deficit duplication, with a view to the economic realities of the particular liquidation.

Inter-Affiliate Financing

On a final note, before concluding, we would draw your attention to certain issues that arise under the Regulations in the inter-affiliate financing context. In particular, we refer to the Regulations that correspond to the provisions in paragraph 95(2)(a) of the Act. These would be set out, *inter alia*, in proposed subparagraph (d)(ii) of the definition of "exempt earnings" and proposed subparagraph (c)(ii) of the definition of "exempt loss" in Regulation 5907(1) (hereafter, the "95(2)(a) Regulations".

In principle, the additional conditions for the application of the 95(2)(a) Regulations (over and above the conditions in the corresponding provisions in paragraph 95(2)(a) of the Act) should be designed to distinguish between treaty-country and non-treaty-country income flows and assets, but not otherwise. Thus, for the purposes of the modified paragraph (c) of the definition of "excluded property" applicable in the context of clause (H) of the 95(2)(a) Regulations, all assets that give rise to exempt earnings to their recipients, or would give rise to

[32] What is not clear is why the rules in proposed Regulations 5905(7)(b) and (c) would increase the higher-tier affiliate's ED or TD, as the case may be, by the "total of" its proportionate share of the liquidating affiliate's ED or TD and the amount, if any, by which this amount exceeds any reduction to its ES or TS under proposed Regulations 5905(7)(d) and (e). Arguably, to the extent that a higher-tier affiliate's proportionate share of a liquidating affiliate's deficits are applied to reduce its ES or TS under proposed Regulations 5905(7)(d) and (e), then that part of such proportionate share of the liquidating affiliate's deficits should not be applied again to increase its ED or TD under proposed Regulations 5905(7)(b) and (c). To do so would seem to be duplicative. Thus, it would seem that these references to the "total of" should be replaced with references to the "lesser of".

such exempt earnings if there were income from those assets or if those assets were disposed of, should qualify as "excluded property".[33] A similar rule should also be put in with respect to excluded property described in proposed paragraphs (a) and (c.1) of that definition in subsection 95(1). With respect to excluded property described in paragraph (b) of that definition in subsection 95(1), we would suggest the reintroduction of a rule such as that in subclause (H)(IV) of the current 95(2)(a) Regulations, with certain refinements, such that it would read as follows:

> "(IV) the shares of a foreign affiliate (in this subclause referred to as the "non-qualifying affiliate") of the taxpayer that is not resident and subject to income taxation in a designated treaty country are not considered relevant for the purpose of determining whether shares of another foreign affiliate (in this subclause referred to as the "tested affiliate") of the taxpayer are excluded property unless the shares of the tested affiliate would not have been excluded property if the shares of all such non-qualifying affiliates were not excluded property and the tested affiliate had no property that did not constitute excluded property for the purposes of this clause other than the shares of all such non-qualifying affiliates owned by the tested affiliate,"[34]

Moreover, this issue also arises in connection with other clauses in the proposed 95(2)(a) Regulations. In particular, we refer to clauses (L) and (M) of the proposed 95(2)(a) Regulations. Neither of these would seem to include items owing by partnerships, or items such as trade accounts receivable or certain loans and lending assets that generate exempt earnings.

Conclusions

As noted throughout this Submission, we have significant continuing concerns with respect to certain aspects of the proposed amendments to the foreign affiliate rules. While many of the proposed amendments are technical and relieving in nature, others seem to introduce restrictive – and, in some cases, unduly burdensome – departures from current rules and underlying principles. Moreover, in our view, while many of the proposed amendments would

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[33] As currently drafted, the language in subclause (H)(III) of the proposed 95(2)(a) Regulations would seem to exclude (or in any event does not sufficiently clearly include) amounts receivable from related non-resident corporations or partnerships because the latter are not actually entitled to deduct payments thereunder in computing their exempt earnings, because they have no exempt earnings as such, and would not seem to cover trade accounts receivable, or loans and lending assets, where the debtor is a third party, since the third party similarly has no relevant exempt earnings. Similarly, and somewhat ironically, this language would seem to exclude a receivable that generates exempt earnings because of clause 95(2)(a)(ii)(D), because the interest expense on such a receivable may be deducted in computing exempt surplus, but not in computing exempt earnings. These assets should qualify as long as they do or would give rise to exempt earnings to the recipient.

[34] However, we would recommend that the reintroduction of this requirement be made prospectively only, in that there may be taxpayers who have relied on its absence in the period between December 20, 2002, and the release of the next version of proposed amendments.

seem to be refined enough at this point to merit proceeding forward to the Technical Bill stage, certain of the proposals, as currently structured or drafted, would in many cases appear to be ineffective, overly disruptive of the scheme of the Act and Regulations in this area, and/or fiscally punitive. In particular, we note the following principal areas of concern:

- The proposed amendments with respect to "internal dispositions" would operate on the basis of a "suspended income and gains" mechanism, the introduction of which would in our view result in numerous anomalies in the distribution of economic values and tax attributes within a chain of foreign affiliates. In addition, we are aware of examples where this approach could result in the punitive taxation as FAPI of gains which accrued on excluded property, as well as in the complete ineffectiveness of the proposed amendments. These anomalies would in our view arise because of structural aspects of the approach being adopted, rather than because of drafting issues.

- The proposed amendments with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates would also appear to give rise to anomalous consequences in many cases, as a result of certain structural aspects of their formulation. In this context, we have seen examples of transactions that would result in the imposition of taxation under the Act in circumstances involving no more than a simple corporate combination or other reorganization that does not in any substantive way alter the indirect economic relationship between the relevant assets or surplus and the relevant taxpayer(s), as well as examples where radically different consequences would arise under the Act or the Regulations depending on whether a merger rather than a liquidation or other reorganization transaction is implemented even though the exact same corporate and commercial result would be achieved either way.

- The proposed amendments with respect to subsection 93(1) elections and adjustments to be made to the various surplus and other accounts of a foreign affiliate as a result of the application of the subsection 93(1) deemed dividend rules, and in the context of certain changes to a relevant taxpayer's surplus entitlement percentage, would also appear to result in anomalous consequences in certain cases, including the over-attribution of underlying deficits and, more generally, the "scrambling" of surplus accounts. In addition, these measures would appear to introduce inordinate uncertainty, complexity and administrative and compliance costs into the system.

We believe that alternative approach could be devised for "internal dispositions" that could address the concerns of Finance in this regard in a manner that would not give rise to such anomalies. Similarly, we believe that the concerns of Finance with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates could be addressed in a more conceptually coherent manner, and more consistently with certain of the fundamental principles that underlie the scheme of the Act and Regulations in this area. We also believe that Finance's concerns with respect to the surplus account adjustment rules could be

addressed in a more efficient manner, that would not disrupt the relationship between tax attributes and economic values, and therefore would be more consistent with the underlying purpose of these rules. We would be pleased to discus with you our thoughts in this regard at your convenience.

APPENDIX

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APPENDIX

JOINT COMMITTEE SUBMISSION REGARDING FEBRUARY 27, 2004 FOREIGN AFFILIATE PROPOSALS

All Statutory references are to the *Income Tax Act* (the "Act") unless otherwise specified.

1. SECTION 17

There are numerous technical deficiencies within section 17. Subsection 17(2) in particular is too broad and affects many transactions that should be outside its scope.

The only changes to section 17 contained in the February 27, 2004 draft legislation relate to the application of subsection 17(8). New subsections 17(8.1) and (8.2) are intended to provide an exemption from section 17 for borrowings that replace borrowings that are exempt under subsection 17(8). The fundamental problem, however, is that subsection 17(8) is too narrow and should be expanded. Some of the deficiencies of subsection 17(8) are highlighted by the proposed new rules.

For example, subsection 17(8) only applies to loans or advances and to amounts owing that arose in the course of an active business. In contrast, the scope of subsection 17(1) is such that it applies to all indebtedness. Proposed subsections 17(8.1) and (8.2) also apply to moneys borrowed to replace debts such as unpaid purchase price. As an example, FA1 purchases an asset from Canco, such as intellectual property, in exchange for an interest-free note. The asset is used to earn subparagraph 95(2)(a)(ii) income. The exceptions in subsection 17(8) do not appear to apply because the debt is not a loan or advance and the debt did not arise in the course of an active business of the affiliate.

However, if Canco makes a non-interest-bearing loan to FA1 in circumstances where FA1 uses the funds to repay the debt in respect of the unpaid purchase price, the new loan appears to be exempt from section 17. This would appear to be the case even though the original debt would not have been eligible for subsection 17(8) treatment. In these revised circumstances, proposed subsections 17(8.1) and (8.2) should apply such that the loan will be deemed to have been used to acquire the intellectual property. As such, the prerequisites of subsection 17(8) should be satisfied.

Consider another example: Canco owns FA1 that has made a loan to FA2 to which subparagraph 95(2)(a)(ii) applies. Canco transfers FA1 to New FA in exchange for shares and an interest-free note. Subsection 17(8) would not apply to the note payable by New FA to Canco. The solution described above (Canco makes a loan to New FA that New FA uses to repay the note) which does not work here because the acquisition of shares is not a permissible use of borrowed funds under subsection 17(8).

Finally, the Canada Revenue Agency ("CRA") has stated that subsection 17(8) will not apply where an affiliate uses borrowed funds to pay a dividend or return capital. In their view, such funds are not used for the purpose of earning income from an active business.

***Recommendations*:**

The exception in 17(8) should be extended to apply to:

(i) all forms of indebtedness;

(ii) circumstances where the debt relates to the acquisition of shares of another foreign affiliate that are excluded property; and

(iii) funds used to pay a dividend or return capital.

We also recommend that a review be made of section 17 as a whole. For example, there still appear to be existing problems with subsection 17(2) based on CRA's interpretation in *Technical Interpretation* 1999-0007790 that if indebtedness between non-residents is subject to subsection 17(2), no consideration would be given to the fact that the Canadian resident corporation may have only loaned or transferred a portion of the funds that resulted in the indebtedness. We recommend that the post-amble of subsection 17(2) be revised to read

> "…the non-resident person is deemed at that time to owe to the corporation an amount equal to the *portion of the* amount owing to the particular person or partnership *that reasonably relates to the amount of the loan or transfer of property made or to be made by the corporation*."

2. SUBSECTION 88(3)

(a) It is not clear, from a policy perspective, why the foreign affiliate shares that are the "distributed property" in paragraph 88(3)(a) must be excluded property to be disposed of by the disposing affiliate at ACB. From a policy perspective, there does not appear to be anything wrong with non-excluded property being transferred to a shareholder at ACB, in particular, in circumstances that are usually governed by foreign tax or non-tax considerations and planning. Permitting a rollover results in the importation to Canada of a latent gain. As such, the gain is not "escaping" the Canadian tax net.

(b) These comments also apply to a number of the new/revised "rollover" provisions (*i.e.*, paragraphs 95(2)(d), 95(2)(e), 95(2)(e.3), 95(2)(e.4), 95(2)(e.5)).

(c) Consider the following example: A Canadian-controlled private corporation ("CCPC") is planning to liquidate a wholly-owned foreign affiliate that owns non-excluded property with significant unrealized gains. If the CCPC had owned those properties directly in Canada it would be entitled to include ½ of the gain in the capital divided account and would then pay tax on the taxable portion. Proposed subsection 88(3) currently results in "double tax" because the FAPI gain created from a deemed sale of the property at fair market value creates exempt surplus which would essentially be treated as a deemed dividend by making a subsection 93(1) election but no amount is added to the capital dividend account.

(d) Is it to be inferred from paragraphs 88(3)(e) and (f) that the phrase "distribution of property" is intended to refer to only those types of circumstances described in those paragraphs (*i.e.*, it is not intended to be a distribution that is legally a dividend)? If the answer to both questions is "yes", then it is suggested a different term be used or that this term be defined to exclude dividends. If that amendment is not made, it would appear that paragraphs 88(3)(e) and (f) could apply to a dividend. Further, an amendment is needed in paragraph 53(2)(b) to properly deal with subparagraph 88(3)(e)(ii).

(e) Is paragraph 88(3)(f) intended to deal with situations where the "distribution" is neither a dividend nor a distribution described in paragraph 88(3)(e)? Presumably subsection 15(1) is not to apply if paragraph 88(3)(f) does, but there has been no change to subsection 15(1). Arguably, subsection 15(1) should not apply to a distribution by a foreign affiliate. Also, we query why a distribution in excess of ACB and surplus should be included in income rather than resulting in a capital gain (as with a pre-acquisition surplus dividend under subsection 40(3))?

(f) At the end of subparagraphs 88(3)(e)(i) and (ii), there are references to "the particular share". What happens if FA originally issues, say, Class 1 shares which creates the share premium and later FA reorganizes or converts the Class 1 shares to Class 2 shares. FA returns the share premium on the Class 2 shares. Is the tracing of the share premium lost because FA did not receive any share premium for the issuance of the Class 2 shares? Does this require that share premium be tracked on a "per share" basis? Say in year 1 FA receives $1,000 and issues 100 shares for $100 PUC and $900 premium. In year 2 FA receives $10,000 and issues another 100 shares for $100 PUC and $9,900 for premium. Because the premium is allocated to all the shares of that class pro-rata, the return of premium on the first 100 shares is more than what FA received on issuance of those shares. What is the intention?

(g) Another issue could arise where contributed surplus or retained earnings attributable to exempt surplus or taxable surplus with high underlying foreign taxes is transferred under foreign corporate law to the registered capital account. In this case, the amount may not have been originally contributed for the issuance of the share. When a distribution is made it is treated under foreign law as a return of capital rather than a dividend. Under current rules that distribution reduces the tax basis of the shares. Under the proposed changes that distribution is treated as income from property. In these circumstances, it would be helpful if Finance could clarify whether it intended to capture distributions that, because of foreign law, were transferred to registered capital but otherwise result in a distribution of exempt earnings or reduction in basis of the foreign affiliate shares.

(h) Subparagraph 88(3)(e)(ii) – it is not clear whether this provision only allows a return of contributed surplus that is contributed by the current Canadian taxpayer that is receiving the distribution. We understand this is not intended, but the language could be clarified. This could be a problem if the Canadian taxpayer is

not the original owner of FA (*i.e.*, Canco acquires FA from another Canco under one of the rollover provisions like subsection 85(1), sections 87, 88, etc.).

We understand Finance is considering various modifications to subsection 88(3).

3. SUBSECTION 93(1)

Netting is a significant departure from current principles and may have adverse consequences in replacing surplus with adjustments to ACB. ACB is generally a function of the shareholder's calculating currency and surplus is generally a function of the affiliate's calculating currency, so the latter will generally better reflect the economic value available for distribution in the currency in which it is maintained – which is an important principle of the surplus regulations. It should be approached with caution, if at all.

4. SUBSECTION 92(1.3) AND REG 5911

There is a potential problem when ACB is used as proceeds or is to be adjusted by way of subsection 92(1.3) and Reg 5911 in circumstances where the ACB is old carryover ACB that is, in effect, bumped up by virtue of paragraph 95(2)(f). An example illustrates our concern. Assume a circumstance in which FA acquires FA1. At the time FA acquires FA1, the shares of FA2 have an accrued gain. Later, FA1 sells FA2 to a specified purchaser. In those circumstances, it would appear that the suspended gain is, based on the historic cost of the shares of FA2 to FA1, and not on the value of FA2 when FA1 was acquired. This would also be an issue if FA2 were property other than shares. Should not paragraph 95(2)(f.91) be relevant for surplus purposes to all types of property?

5. SUBSECTION 95(1) – DEFINITION OF CONTROLLED FOREIGN AFFILIATE

There are two changes to the definition of controlled foreign affiliate ("CFA") in subsection 95(1). The first change deems a taxpayer to own shares owned by certain listed persons for the purpose of determining if the taxpayer controls the corporation. The second change to the definition of CFA is the addition of new subparagraph (c)(iv).

(a) The first change is intended to address the decision of the Federal Court of Appeal in *Silicon Graphics.* Although that decision dealt with the definition of CCPC, the same principles likely would apply to the CFA definition. That decision held that there must be a common connection among shareholders for them to be considered to "control" a corporation; one does not merely add up the number of shares held by each shareholder. The February 27, 2004 proposal is proposed to be effective for taxation years commencing after 1995. It is disrespectful of the judicial system, and unfair to taxpayers who correctly adopted a different interpretation of the CFA definition than the CRA, to amend the definition on a retroactive basis.

***Recommendations*:**

From a policy perspective, it is unclear that the test in the foreign affiliate regime should be merely an additive one. However, as a minimum, the amendment, which will ensure this result, should only be effective on a prospective basis, for years commencing after February 27, 2004.

The second change will deem the taxpayer to own any shares of the non-resident corporation owned by a person that does not deal at arm's length with a person resident in Canada described in subparagraph (c)(iii). We have three comments about this proposed change.

(i) The extension of the definition is too broad and should be eliminated. It is unreasonable to ask Canadian taxpayers to determine whether any other shareholders meet these criteria. This information is not available from the perusal of the share register of the corporation. Further, non-resident shareholders would be under no obligation to provide Canadian shareholders with information relevant to the issue.

While the tested taxpayer might well be expected to "know" or be able to identify other shareholders, that taxpayer's ability to go "above and beyond" evident shareholdings is not practical or reasonable and is never what the test or the system has contemplated. It is unnecessary to make the consequences for Taxpayer #1 dependent on those for Taxpayer #2; the same test applies, independently, for Taxpayer #2, for which a FA may be a CFA even if it is not for Taxpayer #1. Through the section 91 calculation, the "right" amount of income will be brought to account currently, and as well the application will be consistent with the "control" concept.

(ii) If the proposal is to be maintained, it is unclear whether the person resident in Canada referred to in the provision must also be a shareholder of the non-resident corporation. If the test is a non-arm's length relationship with any Canadian resident, rather than a Canadian resident shareholder, the test will be even more unworkable. The reference to a "person resident in Canada" should be changed to a "shareholder resident in Canada".

(iii) If the proposal is to be maintained, the test should be changed from a non-arm's length test to a test of relationship. This would at least provide a degree more certainty with respect to the scope of persons to be included.

(iv) If the proposal is to be maintained, subparagraph (iv) should be restricted to persons who are not resident in Canada. If the non-arm's length persons referred to in subparagraph (iv) can be other Canadian residents, which is the case as currently drafted, that would appear to be contrary to the policy behind the "not more than 4 Canadian residents" test in

subparagraph (iii). For example, assume the Taxpayer owns 10% of a non-resident corporation. Mr. A owns 10%, Mr. B owns 10%, Mr. C owns 10%, Mr. D owns 10%, Mrs. A owns 1% and a NR shareholder who is arm's length with everyone owns 49%. The only non-arm's length persons are Mr. and Mrs. A. The non-resident corporation would be a CFA of the Taxpayer because Mrs. A would be a person described in subparagraph (iv) even though the non-resident corporation would not be a CFA taking into account the shareholdings of the taxpayer and 4 or fewer Canadian residents.

(b) The CFA test is also affected by new supporting rules in paragraphs 95(2)(u) - (x), which deem shares held by certain corporations, partnerships and trusts to be held by the respective shareholder, partner, settlor or beneficiary. The attribution of ownership is based on the fair market value of the interest in the relevant entity: voting control has become irrelevant. We have the following comments concerning the proposed rules.

(i) We understand that the rules have been proposed in response to planning previously undertaken by certain taxpayers to multiply the number of shareholders in a foreign corporation to avoid the "4 or fewer" Canadian resident test. It is our understanding that most of the structures with which Finance was concerned would now be caught by the foreign investment entity rules. That being the case, the Committee queries whether the introduction of such broadly applicable new rules is necessary.

(ii) The Committee would like to understand from a policy perspective why the concept of control was removed from the CFA definition. For example, if a shareholder holds non-voting preferred shares, it is unclear why the CFA test should ever be met.

(iii) The test also leads to odd results. If the taxpayer owns preferred shares of FA1 representing more than 50% of the value of FA1 and FA1 owns FA2, FA1 may not be a CFA of the taxpayer (if the common shares are owned by an arm's length non-resident for example) but FA2 will be a CFA, due to the application of paragraph 95(2)(u).

(iv) The look-through rules with the broadened definition of CFA can result in double counting. By way of example, if taxpayer owns 25% of FA and 40% of a related non-resident corporation ("NRCo"). NRCo owns 20% of FA. It appears that the taxpayer will be attributed with both the 20% of FA owned by NRCo and 20% of 40% = 8% of FA through NRCo. This would result in taxpayer being deemed to own 53% of FA, instead of 45%.

(v) The interaction of the look-through rules and the broadened definition of CFA in subsection 95(1) would appear to lead to the extension of the CFA concept beyond what may have been intended. For example, assume Canco A, an arm's length Canadian taxpayer, owns 50% of the shares of

For Corp 1 which owns 50% of For Corp 2. The taxpayer owns the other 50% of For Corp 2. Under the proposed definition of CFA, assuming that For Corp 1 deals at arm's length with Canco A, the taxpayer will not be deemed to own the shares of For Corp 2 owned by For Corp 1, and For Corp 2 should not be a CFA. However, if paragraph 95(2)(u) is applied, Canco A is deemed to own 25% of the shares of For Corp 2. Under the definition of CFA, the taxpayer would be deemed to own the shares of For Corp 2 deemed owned by Canco A and For Corp 2 would become a CFA.

Recommendations:

(i) In view of the above, the Committee does not see the need for the extension of the CFA definition in the manner proposed and suggests that these proposals be withdrawn.

(ii) As a minimum, if the proposals are not withdrawn, Finance should introduce a rule to prevent the double counting of shares in the determination of CFA status.

6. SUBSECTION 95(1) – DEFINITION OF EXCLUDED PROPERTY

As noted in our previous submission, a context in which the proposals narrow the scope of excluded property is in respect of goodwill and inventory of an investment business which generates active business income in accordance with paragraph 95(2)(a). That is, such property is not used to earn income from an active business carried on by the affiliate, because the affiliate is not deemed by paragraph 95(2)(a) to be carrying on an active business, even though it recharacterizes the income from the business as income from an active business. Thus, such property would not be covered by paragraph (a).

In addition, such property might not be covered by paragraph (c) because the affiliate will generally not, as such, derive any income "from" such property (as opposed to from the disposition of such property, in the case of inventory) and it would appear to be difficult, if not impossible, to apply the "would be" part of the test in the absence of any statutory guidance or assumptions as to how that hypothetical income would be earned. A similar issue does not arise, for example, in the context of a loan, because it would be reasonable to conclude that the hypothetical income from this property would be interest payable by the borrower. However, a similarly reasonable conclusion is difficult to reach in the case of inventory or goodwill.

Recommendation:

Accordingly, we submit that the proposed definition of "excluded property" should be revised to address this concern, by introducing a new category of excluded property, which could refer to:

> *(d) goodwill and inventory associated with a business carried on by the affiliate where the fair market value of the property (other than goodwill and inventory) of an affiliate*

which is excluded property represents all or substantially all of the fair market value of all the property (other than goodwill and inventory) of the affiliate

7. SUBSECTION 95(1) – DEFINITION OF INVESTMENT BUSINESS

The Committee wishes to reiterate the comments made in its Submission of September 18, 2003 with respect to the December 20, 2002 draft proposals relating to the investment business definition. The proposed rules, in the 2002 and 2004 draft legislation, do not accommodate many common business structures. We believe that the exceptions to the investment business test need to be reconsidered with a view to the policy objectives of the provisions. Our recommendations in our previous submission included the following key points.

(i) A reasonable expansion of this rule would be to permit the employees of related foreign affiliates (and partnerships of which such affiliates are qualifying members) who are actively engaged in the conduct of similar and related businesses (defined appropriately) to be aggregated for the purposes of relevant affiliates (or partnerships) satisfying the "more than five" full-time employee test.

(ii) It remains unclear why the status of the employer is even relevant at all. That is, if the purpose of the more than five employee test is to distinguish business activities which require substantial foreign manpower from those which do not, why should it matter that the manpower is procured under a contract of employment *versus* independent contractorship? This may be particularly inappropriate in certain industries, such as the real estate industry, where the use of contractors (*i.e.*, management and service companies) is industry practice. In addition, in some cases practical efficiencies and commercial objectives can be achieved by "outsourcing" employees.

(iii) Given the uncertainty resulting from various CRA technical interpretations, the Committee recommends that subparagraph 95(2)(a)(i) be clarified such that it clearly would be applicable in circumstances in which a foreign affiliate group is divided into, for example, one affiliate which has all the employees and other affiliates which have no employees and instead are used to hold distinct properties or otherwise to carry out distinct functions, provided that such properties and functions are managed or coordinated by the employees of the employee affiliate.

The extension of the employee equivalents exception to include employees provided by "designated corporations" and "designated partnerships" is welcome but does not address the fundamental issues described above. With respect to the definitions specifically, the Committee is of the view that they should be expanded to better accommodate joint venture arrangements. For example, a qualifying member of a partnership can provide the employee equivalents to the partnership, even if that qualifying member deals at arm's length with the taxpayer. However, with a partnership arrangement, it is common for a corporate partner to set up a new wholly-owned corporation to act as the partner. This corporation typically would not have employees, particularly if it is intended to be a limited partner. As the provisions are currently drafted, the shareholder of that qualifying member cannot provide the employee equivalents. It would appear that the same entity

may be able to provide the employee equivalents if the joint venture were carried on in corporate form rather than as a partnership.

Recommendations:

We recommend that subclauses (b)(ii)(B)(II) and (III) of the definition of investment business be amended to read as follows:

(II) a designated corporation in respect of a qualifying member of the operating partnership, or

(III) a designated partnership in respect of a qualifying member of the operating partnership.

In both cases, the affiliate must still be a qualifying member of the operating partnership due to the preamble to paragraph (b). The recommended change allows the designated corporation and designated partnership tests to also apply in respect of another qualifying member, not just the affiliate.

As noted, joint ventures using corporations are more likely to be able to meet the test as proposed. However, for clarity, it may be appropriate to also amend subclauses (C)(II) and (III) to read as follows:

(II) a designated corporation in respect of a qualifying shareholder of the affiliate, or

(III) a designated partnership in respect of a qualifying shareholder of the affiliate.

Consequential amendments to paragraphs 95(2)(s) and (t) would be required to define designated corporation and designated partnership with respect to a person, rather than with respect to an affiliate.

8. CLAUSE 95(2)(a)(ii)(D)

The rule in clause 95(2)(a)(ii)(D) is intended to facilitate certain types of foreign affiliate acquisition financing arrangements. This rule has often been very difficult to apply, in part because of its restrictive nature. Our specific comments on the rule are as follows.

(a) To the extent the interest expense incurred by the second affiliate is deducted/added in computing the surplus/deficit of the third affiliate in a particular year, the adjusted cost base of the shares of the third affiliate held by the second affiliate should be increased by the same amount at the end of the year. To the extent that such an amount is deducted by a lower-tier affiliate in computing its surplus accounts, the adjusted cost base of the shares of the affiliate held by third affiliate and by any other affiliate in which the third affiliate has an equity percentage should be increased by the same amount at the end of the year.

(b) The adjustment to surplus and deficit balances of an affiliate would have to take into consideration situations where the taxpayer's surplus entitlement percentage in the affiliate is less than 100%.

(c) It is not clear what is meant by the particular period in the year and if offside for some part of the year - can it be remedied?

(d) There is still a requirement that the second and the third affiliate be resident in the same country. Is this really required, given the proposed changes in the regulation? What about developments in the EU?

(e) Assume a second affiliate and third affiliate referred to in clause 95(2)(a)(ii)(D) and the affiliate to which the second affiliate pays interest (the first affiliate) have calendar taxation years. The second affiliate is a U.S. C corp and the third affiliate is an LLC that is disregarded for U.S. tax purposes but is resident in the U.S. under Canadian tax principles. Interest is paid quarterly. In the fourth quarter of the year, the second affiliate sells the LLC to a non-U.S. person. It does not appear that subclause (V) would be satisfied for the interest paid for any of the four quarters of the year if the members of the LLC at the end of the LLC's taxation year that coincides with the taxation years of the first and second affiliates in which the LLC was sold would not be subject to tax in the U.S. on the LLC's income. Perhaps, if the LLC were carrying on business in the U.S. through a permanent establishment there, the non-U.S. members would be taxable in the U.S., but it appears there is a potential problem here.

(f) We query whether the reference in variable D of Reg 5907(2.81)(c) to "specified foreign affiliate" should be a reference to "group foreign affiliate".

(g) Reg 5907(2.82) refers to an amount paid or payable referred to in paragraph 5907(2.81)(a), but that paragraph does not refer to an amount paid or payable. Query whether it was intended to refer to the amount paid or payable in paragraph 5907(2.8)(b) of the Regulations.

(h) Reg 5907(2.81) should not reduce exempt surplus if the related interest is included in taxable earnings of the first affiliate in circumstances where the second and third affiliates are not resident in designated treaty countries or the third affiliate has significant assets that are generating paragraph 95(2)(a) recharacterized income that is not deductible by the payer from exempt earnings or loss.

(i) In the corresponding Regulation, why is the substituted language for paragraph (c) of the definition of "excluded property" so narrow? It also should pick up property that gives rise to income that is included in exempt earnings, even where there is no corresponding deduction in computing another affiliate's exempt surplus, such as factoring arrangements. These are cases in which, although there is no deduction, there is a shifting of exempt earnings, so they should qualify.

(j) In sub-subclause (V)1., what is meant by "subject to income taxation"? For example, if the third FA is a European holdco and receives dividend income that's exempt under the participation exemption, is the test still met? Presumably the answer is "yes".

9. PARAGRAPH 95(2)(b)

The adoption of the arm's length test is, we understand, largely to address cases of directed income or benefit. Without some qualification similar to subsection 56(2) limitations, there will be cases when this provision will be difficult if not impossible to apply properly.

Recommendation:

We recommend that

(a) the non-arm's length case be a separate case than the related person case, and

(b) in the non-arm's length case there be a connection to the income diversion limit served by this rule, by incorporating the opening words of subsection 56(2).

10. PARAGRAPHS 95(2)(c.1) - (c.6)

(a) If it is considered appropriate to prevent the realization of surplus on the transfer of one foreign affiliate by another to a third affiliate, why should that logic not also apply to gains arising on the transfer of shares that are not excluded property? In other words, why is there no elective rollover for transfers of shares that are not excluded property, such as in the case of paragraph 95(2)(c)? Either an "internal" disposition is "real" or it is not. It should not be "real" when it would be taxable, and "not-real" when it would give rise to good surplus.

(b) Clause 95(2)(c.2)(v)(A), does not seem to be net of any subsection 93(1) election. This is a technical issue with the drafting of the provision.

(c) Paragraph 95(2)(c.3) could be clearer: the "relevant foreign affiliate referred in paragraph (c.2)" is the vendor. Also, why does not the disposition of the shares of the vendor to a third party result in the recognition of a capital gain in the vendor? At the very least, the unsuspended surplus should be available for a subsection 93(1) election on such a disposition.

(d) There should be a 30-day "window" to facilitate the movement of assets as part of a series of transactions resulting in third-party sale, as with the domestic stop-loss rules. A "30-day" rule which prevents the application of the suspension rules if the specified share (or specified property) is not owned by a specified purchaser within 30 days, should be implemented. This also is relevant in the other proposals regarding suspended gains on internal dispositions.

(e) What happens to the suspended gain if the vendor is liquidated into its Canadian shareholder under subsection 88(3)? Appears to be lost. Also appears to be lost in some cases where the vendor is liquidated or merged and paragraphs 95(2)(d.1) or (e.1) does not apply.

(f) What happens where FA shares that are excluded property with a latent gain are transferred to another FA as a capital contribution? It seems proceeds will be determined as ACB plus subsection 93(1) deemed dividends, but the unadjusted suspended gain could be nil because it is computed as a function of the FMV of the consideration received by the vendor. In the context of a capital contribution, there is a debate as to whether the vendor receives any consideration as a matter of law, and this may depend on the particular governing law and the specific steps taken by the relevant parties.

(g) There is a technical problem with paragraph (b) of the definition of "triggering disposition" in subsection 95(3.3) which precludes a triggering disposition where there is a disposition to a third party as part of the same series as an acquisition by a specified purchaser, even if the acquisition is before the disposition. This concern could be addressed by having a "30-day" rule.

(h) Paragraph 95(2)(c.4) – What happens if the specified shares are redeemed on a dividend-like redemption? When is the suspended gain liberated in such a case?

11. PARAGRAPH 95(2)(d)

(a) Why should a FA not be entitled to a rollover in respect of shares it owns in a foreign corporation that is not a foreign affiliate of the taxpayer if that foreign corporation is involved in a foreign merger? No requirement for predecessor foreign corporations to be a foreign affiliate under subsection 87(8). Also, not evident that subsection 85.1(5) would apply?

(b) If no rollover is available for property that is not excluded property, why is it not possible to have subsection 93(1) apply to reduce FAPI where the property is shares of a foreign affiliate? (Note: there is no preclusion to filing a subsection 93(1) election in proposed paragraph 88(3)(b).)

(c) Clause 95(2)(d)(iii)(A) should also apply if the shares disposed of on the foreign merger are not excluded property.

(d) Does revised wording preclude triangular mergers? Surely, there is no intention to do so because there is no change in this regard to subsections 87(8) or 87(8.1). See also definition of new corporation in paragraph 95(2)(d.1), which no longer refers to "the foreign parent corporation".

(e) What is the intention and surplus implications of the deemed year-end rule?

(f) It is assumed that the reference to "new foreign corporation" in paragraph 95(2)(d) (and (d.1)) is the entity as defined in subsection 87(8.1) but this should be clarified.

(g) There is no definition of "specified vendor" for paragraph 95(2)(d).

(h) Where there is a deemed disposition at FMV (subparagraph 95(2)(d)(i)) or greater than ACB (subclause 95(2)(d)(iii)(A)(II)), there is no rule indicating when the disposition occurs. Where there is an actual disposition at FMV (*i.e.*, shares of a predecessor which are not excluded property) there is no guidance as to when the disposition occurs. The timing of such dispositions may be important to properly determine surplus accounts (particularly where the shares of a predecessor result in a gain and a subsection 93(1) election is available – it is only subparagraph 95(2)(d)(i) dispositions which cannot use subsection 93(1)).

12. PARAGRAPH 95(2)(e)

(a) If no rollover is available for property that is not excluded property, why is it not possible to have subsection 93(1) apply to reduce FAPI where the property is shares of a foreign affiliate? (Note: there is no preclusion to filing a subsection 93(1) election in proposed paragraph 88(3)(b).)

(b) Subparagraph 95(2)(e)(v) - since any gain would be FAPI even if the shares are excluded property, why not deem gain to be nil unless taxpayer elects for there to be a gain (*i.e.*, do something similar to paragraph 95(2)(c.2) and clause 95(2)(d)(iii)(A))? Same treatment should be considered even if the shares are not excluded property (*i.e.*, rollover of shares available under paragraph 95(2)(e.1) regardless of whether shares of disposing affiliate are not excluded property).

(c) Subparagraph 95(2)(e)(vii) (deemed year end), what is this intended to do? How does this affect surplus computation?

(d) FAPI could arise in circumstances it should not. For example, FA could be carrying on an active business and its shares would be excluded property. In the course of a liquidation all assets are distributed. At a later time (which could be a year or more later), the shares of FA are disposed of by the shareholder on the formal dissolution of FA. Subparagraph 95(2)(e)(iv) determines POD of the shares of FA. Subparagraph 95(2)(e)(v) does not appear to suppress the gain because at the time of disposition the shares of FA would not be excluded property.

13. PARAGRAPHS 95(2)(d.1) AND (e.1)

(a) Foreign tax treatment – why is this relevant? The requirement is too harsh, especially if there is no rollover for non-excluded property under paragraphs 95(2)(d) or (e). The 90% surplus entitlement percentage ("SEP") (or other similar) requirement should be enough, and there should be no additional requirement that there be no recognition under foreign tax law. Note also that,

under paragraph 95(2)(d.1), a cross-border taxable merger qualifies but a domestic taxable merger does not qualify.

(b) There are many anomalies in using SEP. The 90% SEP requirement could be replaced with a different threshold to not interfere with legitimate joint venture arrangements – perhaps a "qualifying interest" or related party test should be appropriate in this context as it is in the context of paragraph 95(2)(a). At the very least, the SEP of related persons should be aggregated.

(c) Where paragraph 95(2)(e.1) applies, it is not clear, for surplus purposes, what the cost would be to the shareholder of property acquired on the liquidation. Reg 5907(2.01) may not provide the answer. There are likely other provisions like this.

14. PARAGRAPH 95(2)(e.3)

(a) Why does the structure of this rule not parallel the structure of subsection 88(3), in particular with regard to capital contributions and distributions? Symmetry would be desirable though the changes should also mirror the suggested changes to paragraphs 88(3)(e) and (f).

(b) Does this paragraph envision that a payment can be made in the form of "cash"? It appears so in parts (*e.g.*, subparagraph 95(2)(e.3)(iv)) but it is not clear in others (*e.g.*, subparagraph 95(2)(e.3)(i)), where you have to make a determination of whether the cash is excluded property and if it is, you then have to determine its relevant cost base ("RCB"), not something normally done for cash.

(c) The suspended gain on internal transfers can result in FAPI where it should not occur. If FA's sole asset is real estate (with more than 5 employees) and it is sold internally for cash, paragraph 95(2)(f.4) should apply to defer any gain. But once cash is the sole asset in the FA, the FA shares likely would no longer be excluded property. On a distribution of the cash, subsection 40(3) would likely cause the realization of a gain but subparagraph 95(2)(e.3)(iv) would not appear to eliminate the gain on the shares. In many cases, a liquidation of the FA, followed by the sale would not be commercially desirable.

(d) Why no subsection 93(1) elections?

(e) Subparagraph 95(2)(e.3)(i) - why does it matter whether or not the property transferred is excluded property? It should be transferable at RCB regardless.

(f) The term "distribution" is of a general nature and would normally include dividends, PUC returns, share premium returns and so on. The structure of paragraph 95(2)(e.3) suggests that (perhaps) the term "distribution" in this provision is intended to mean something other than a dividend? For example, a return of PUC or premium. Or does it also include a dividend?

(g) Subparagraph 95(2)(e.3)(iv) only seems to contemplate having a subsection 40(3) gain as a result of a pre-acquisition surplus dividend, not a distribution that is not a dividend. We understand that this was not intended.

(h) Because any gain as a result of subparagraph 95(2)(e.3)(iv) is FAPI, the default provision should be that gain is deemed nil but it could be higher if taxpayer elects, as per paragraph 95(2)(c.2).

(i) A subsection 40(3) gain that is caused by a pre-acquisition dividend is FAPI (new letter B(c) in FAPI definition). There is an election in subparagraph 95(2)(e.3)(iv) to eliminate this FAPI, but subparagraph 95(2)(e.3)(iv) applies to both dividends and distributions. Thus, if the subsection 40(3) gain arose for another reason – say a PUC return – there is no election to eliminate it. We understand this matter is under consideration.

15. PARAGRAPHS 95(2)(e.4) AND (e.5)

(a) Paragraph 94(2)(e.4) results in too much attribute erosion. For example, if FA1 holds 100 common shares of FA2 (having an aggregate FMV of $200) which it acquired for $100, and FA2 has $100 of ES, and FA2 repurchases 50 common shares and pays $100 in cash, there would be a deemed dividend of $100, which would reduce ES to nil, and the $50 of ACB on the 50 shares would be lost: FA1 would have 50 shares worth $100, and only $50 of basis, and FA2 would have no ES. This can be even worse if high-basis preferred shares are redeemed. This cannot be the right result. Arguably, a dividend-like redemption should give rise to a dividend only to the extent that it exceeds basis, and the portion covered with basis should be treated as a return of basis.

(b) Alternatively, if redemptions are to be treated as dividends without regard to ACB, then the ACB of the redeemed shares should be accounted for some how – by adding it to the ACB of the remaining shares.

(c) Paragraph 94(2)(e.4) – This rule should not apply to a direct shareholder whose entire interest is redeemed. Indeed, it should not apply to a shareholder unless there has been a proportionate redemption of that shareholder's interest.

(d) See also comments under paragraph 95(2)(e.3).

(e) Paragraph 95(2)(e.4) applies at a particular time when a shareholder receives a property. Clause 95(2)(e.4)(i)(A) provides a rollover where the property is excluded property of the foreign affiliate "at the particular time". It would appear that this wording should be changed so the test is whether the property was excluded property of the foreign affiliate immediately before the time that it is transferred to the shareholder. This is so because "at the particular time" the property will be the property of the shareholder and therefore it cannot be excluded property of the foreign affiliate. A similar issue is present in clause 95(2)(e.5)(i)(A).

(f) The determination of whether property (*i.e.*, operating assets such as real estate) is excluded property at a particular point in time is affected by subsequent events. For example, if a particular FA has several rental properties and more than five full time employees, the properties should be excluded properties. If after a particular transfer, but in the FA's same taxation year, the number of full time employees is reduced below five, the properties become non-excluded properties as at the beginning of the year and the rollover under paragraph 95(2)(e.4) may be eliminated. See the discussion below in respect of the fresh start rules wherein it is recommended that there should be a deemed year end.

(g) Under the existing legislation it is possible for reorganizations of the capital of foreign affiliates to be carried out on a tax-deferred basis pursuant to subsection 86(1) or 51(1). Subsections 86(1) and 51(1) should apply in the context of foreign transactions since they are not restricted to the reorganization of capital or conversion of shares of a Canadian corporation. Assume that a foreign affiliate ("Parent FA") owns all of the shares of a subsidiary foreign affiliate ("Sub FA"). It is desired to reorganize the capital of Sub FA into more than one class of shares (*i.e.*, from only common shares to new common shares and one or more classes of preferred shares). Under existing law, availability of the rollover to Parent FA would not be dependent upon whether the shares of Sub FA are excluded property. As previously discussed, this is of great practical significance as there is often significant difficulty in ascertaining with certainty whether particular shares are in fact excluded property. It does not appear that proposed paragraphs 95(2)(e.4) and (e.5) were drafted with a share exchange in mind, however, since a "cancellation" of the old shares would almost certainly result it appears the provisions could apply.

(h) In determining the surplus balances of a foreign affiliate where there was an internal reorganization of shares, a potential reduction in surplus arises twice. For example, Canco owns shares in FA. If Canco sells shares in FA for consideration including shares of FA, adjustments to surplus arise under both 5905(2) and 5905(8). While these provisions are consistent, uncertainty arises in determining which provision should be applied. It appears, therefore, that only one of these provisions should apply so that the surplus balances are not adjusted twice.

16. PARAGRAPH 95(2)(f) - COMPUTING GAINS, LOSSES, AND INCOME OR LOSS FROM PROPERTY

Paragraph 95(2)(f) provides for the currency in which certain gains and losses are to be computed. It is proposed that this paragraph be amended to add reference to capital gains and capital losses (in addition to taxable capital gains and allowable capital losses), to add reference to gains and losses from the disposition of property by a partnership, and to add reference to the relevant taxpayer. Arguably, each of these references would simply result in greater clarity, with the possible exception of the addition of the reference to property owned by a partnership in the midamble.

From a policy perspective, it would appear appropriate to exclude that portion of any gain or loss arising on the disposition of property by a partnership, which was owned by the partnership at the time an interest in the partnership was first acquired by an affiliate, that can reasonably be considered to have been accrued during the period that the affiliate did not own an interest in the partnership.

***Recommendation*:**

The midamble should be further revised as follows:

> …..at the time the affiliate last became a foreign affiliate of the taxpayer*, or at the time the affiliate last acquired an interest in the partnership, as the case maybe,* there shall not……..that the affiliate was not a foreign affiliate of*, or the partnership did not have a member who was,*

17. PARAGRAPH 95(2)(f.1)

(a) New paragraph 95(2)(f.1) provides that the income or loss from property of a foreign affiliate must be computed in Canadian currency. This provision would also require the income or loss from property of a foreign affiliate to be computed in accordance with Part I of the Act as though the affiliate were resident in Canada assuming the Act were read without reference to subsections 14(1.01) to (1.03), 17(1) and 18(4) and section 91. Finally, the provision excludes from income or loss from property income or loss that accrued during the period when the affiliate was not a foreign affiliate of the taxpayer and certain other specified persons.

Recommendation:

We agree that the exceptions in proposed subparagraph 95(2)(f.1) are appropriate but are concerned that, in certain situations, other provisions in the Act should also not apply with respect to the computation of income or loss of an affiliate from property or from a business other than an active business. For example, we submit that it would be inappropriate for FAPI to arise with respect to a non-interest bearing loan pursuant to either subsection 15(2) or 247(2). In addition, it would not be appropriate for certain other anti-avoidance rules, such as subsection 55(2), to apply.

It would be preferable to clarify that a provision in the Act will not apply for these purposes if it would be unreasonable for the provision to apply in a foreign affiliate context.

The clarification should further provide that subparagraph 95(2)(f.1)(i) is only applicable for purposes of computing FAPI and for greater certainty does not result in the foreign affiliate being considered to be resident in Canada for other purposes of the Act (*i.e.*, any provision of the Act that only results in a charge to tax for Canadian residents). However, residence may be required for certain

elements of computing FAPI (*i.e.*, a deduction for cumulative foreign resource expense).

Further, the Minister should be given the power to prescribe future exceptions. In any event, the intention as to the scope of proposed paragraph 95(2)(f.1) should be made clear in the technical notes.

(b) Further, proposed paragraph 95(2)(f.1) is intended to apply to taxation years that begin after December 20, 2002. Because there may be some non-resident trusts that are caught by new section 94, where such trusts own shares of a foreign holding company, that holding company will become a foreign affiliate and a CFA when the trust is deemed resident on January 1, 2003. If the holding company has a non-calendar year end, new paragraph 95(2)(f.1) would not be applicable to the first year that it is a CFA.

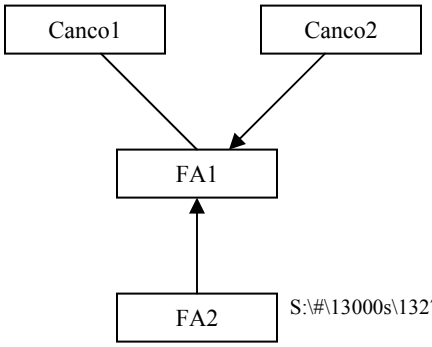
***Recommendation*:**

Paragraph 95(2)(f.1) should apply to years that end after 2002.

(c) Proposed paragraph 95(2)(f.1) also seems to be too narrow in certain respects. In particular, this provision should also deal with accrued debt-forgiveness, and accrued income from a business other than an active business (*i.e.*, paragraphs 95(2)(a.1) to (b)). Moreover, in this respect, the application of proposed paragraph 95(2)(f.1) should be coordinated with the application of proposed paragraphs 95(2)(k) to (k.3). That is, whether or not these provisions would apply in the context of a non-resident corporation that becomes a foreign affiliate, because of an acquisition or otherwise, is not entirely clear.

18. PARAGRAPHS 95(2)(n) AND 95(2)(f.1)

The application of paragraph 95(2)(n) is now restricted. Does this mean we have FAPI in the following scenario: Canco1 owns 100% FA1, which owns 100% FA2. All have Dec. 31 year end. On June 30 FA2 pays $100 dividend to FA1. On July 15 Canco2 invests in FA1 shares, contributes cash in exchange for new shares issued by FA1. Canco2 and Canco1 are related. For Canco2, is not the $100 dividend received by FA1 FAPI? In the definition of FAPI, A(b) only carves out dividends received by FA1 from another FA of Canco2. At the time of the $100 payment by FA2, FA2 is not an FA of Canco2. Paragraph 95(2)(n) does not deem FA2 to be an FA of Canco2. Paragraph 95)(2)(f.1) does not help because it only carves out income of FA1 earned while FA1 is not an FA of anyone in the related group.



19. SUBSECTION 95(2.21) - PRE-ACQUISITION ACTIVE BUSINESS INCOME

Proposed subsection 95(2.21) is introduced to preclude income arising before a non-resident corporation becomes a foreign affiliate of a particular taxpayer from being included in computing the affiliate's income from an active business under paragraph 95(2)(a). This issue arises because of the deeming rules in subsection 95(2.2). Under paragraph 95(2.2)(a), a non-resident corporation which becomes a foreign affiliate of a particular taxpayer in respect of which the taxpayer has a qualifying interest during the course of a taxation year because of an acquisition or disposition of shares is deemed to have been such *throughout the year*. Similarly, under paragraph 95(2.2)(b), a non-resident corporation which becomes related to a particular taxpayer and to a foreign affiliate of the taxpayer during the course of a taxation year because of an acquisition or disposition of shares is deemed to have been such *throughout the year*.[1]

Accordingly, payments made by such a corporation to a foreign affiliate of the taxpayer in respect of which the taxpayer had (or was deemed to have) a qualifying interest throughout the year would seem to qualify for inclusion in the recipient affiliate's income from an active business under paragraph 95(2)(a). However, the price (and, therefore, the ACB) of the recipient affiliate shares which were acquired would presumably reflect the value of the accrued or realized income of the recipient affiliate, so it should not also be reflected in the recipient affiliate's surplus. Such surplus is sometimes referred to as "phantom surplus". The effect of this amendment, together with that of paragraph 95(2)(f.1), which precludes such income from resulting in FAPI, would be to cause such income to result in pre-acquisition surplus.

As originally drafted, it was not entirely clear that this provision would not extend to income earned after foreign affiliate status based on relationships established before. The revised language (for example, in paragraph 95(2.21)(a)) provides that subsection 95(2.2) does not apply "to any income or loss … to the extent that that income or loss relates to a transaction or event … that occurred before that particular affiliate became … a foreign affiliate". We believe that it is possible to interpret this language to describe income earned after foreign affiliate status. For example, where one entity makes a loan to another before foreign affiliate status, and interest is earned on that loan after foreign affiliate status, it could be said that the income earned after "relates" to the making of the loan, which is a "transaction" which occurred before foreign affiliate status. This no doubt is not the intention, so it would be preferable to change the language to clarify it in this respect.

Recommendation:

The closing words in the preamble should be changed to read: "…., to the extent that that income or loss *can reasonably be considered to have been realized or to have accrued*".

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[1] The proposals amend paragraph 95(2.2)(b) to address a technical concern which arises where the non-resident becomes related to the taxpayer before the acquisition of shares because of a right to acquire shares to which paragraph 251(5)(b) applies. In these circumstances, it cannot be said that the non-resident corporation becomes related because of the share acquisition or disposition, since it was related before that event.

In addition, the opening words, "that occurred" in proposed paragraph (a) and (b) should be deleted.

20. PARAGRAPHS 95(f.3) - (f.9)

(a) Why is there no ability to transfer these assets on a rollover basis for shares of the transferee as was previously envisioned in the December 20, 2002 proposals to revised Reg 5907(5.1)?

(b) Why no rollover for non-excluded property?

(c) Why no 30-day "window" rule?

(d) Why is income or gain not released when vendor is sold to a third party? Arguably, it should be available for a subsection 93(1) election on such a sale.

(e) Paragraph 95(2)(f.4) can apply to property that is not capital property, but the "proceeds from the disposition" (note that it does not say "proceeds of disposition", presumably in recognition that the provision can apply to non-capital property) would equal the "adjusted cost base" of the property. What is the ACB of a non-capital property? What is the ACB of ECP or depreciable property? Should not proceeds equal cost amount? There are several places where the proposals are not restricted to capital property but there is inconsistency between the use of "proceeds from the disposition" and "proceeds of disposition" and also between the use of ACB, cost amount, and relevant cost base.

(f) The application of paragraph 95(2)(f.4) to resource property causes particular concerns. "Cost amount" of a resource property is usually considered to be nil, even if there are significant resource pools.

21. PARAGRAPHS 95(2)(h) - (h.5)

(a) Why are these rules not symmetrical to those found in paragraphs 95(2)(c.1) - (c.6) (*i.e.*, why do they not apply to property that is excluded property)? Why should deficits be triggered in the same situation that surplus could not? Why the difference between Reg 5907(2)(f) and (j)?

(b) How do these provisions reconcile with the stop loss rules in paragraph 40(2)(e.1) regarding inter-company loan receivables? Paragraph 40(2)(e.1) trumps subsection 40(3.4). Does it also trump paragraph 95(2)(h.1)? We are not sure why paragraph 95(2)(h.1) only refers to subsection 40(3.4) – what about "superficial loss" rules?

(c) In a circumstance where there is an inter-affiliate promissory note which has a FMV less than the cost (face amount), on a transfer of such note (assuming it is not excluded property) to a specified purchaser, paragraph 95(2)(h.1) will suspend the loss until a "triggering disposition" occurs. In circumstances where the note is subsequently settled and extinguished, there does not appear to be any means to

"liberate" the suspended loss. The definition of "triggering disposition" in subsection 95(3.5) contemplates that there must be a disposition "to a person or partnership that is not a specified purchaser". In these circumstances, it appears that any FAPL in the debtor affiliate will be ground on the settlement of the obligation, however, the FAPL incurred by the original creditor affiliate on the internal transfer does not appear to be crystallized.

22. PARAGRAPH 95(2)(k) - (k.6) – FRESH START RULES

The proposed amendments to paragraphs 95(2)(k) to (k.6) substantially change the application of the fresh start rules.

(a) Accrued Active Income and Gains

Paragraph 95(2)(k) sets forth the criteria for the application of paragraph 95(2)(k.1) which replaces existing paragraph 95(2)(k). The proposed amendments would apply essentially to a foreign affiliate or partnership ("the operator") that changes from carrying on an active business to carrying on a business (a "Passive Business") which gives rise to income from property (*i.e.*, an investment business, or a paragraph 95(2)(l) business) or income from a business other than an active business (*i.e.*, a business described in any of paragraphs 95(2)(a.1) to (b)). This definition of Passive Business would represent an expansion of the fresh start rules as compared to the current definition of foreign business.[2]

We have identified the following concerns with respect to the current proposed amendments in this regard.

(i) The timing of the deemed disposition, of the property used in the active business, would be immediately before the beginning of the taxation year ("specified taxation year") in which the change occurs from an active business to a Passive Business. Thus, there would be a deemed disposition at the end of the year throughout which the business was an active business. This timing is perhaps somewhat inaccurate, in that income and gains accruing during the specified taxation year but before the event which gave rise to the change in status would be treated as passive income and gains.

Recommendation:

We recommend this timing be reconsidered, and that it may be appropriate for an affiliate that experiences this type of change in the status of its business be deemed to have had a year end immediately before the change, and to have had a deemed disposition immediately before that

[2] A foreign business is currently defined in paragraph 95(2)(k) to include an investment business or a business deemed by paragraphs 95(2)(a.1) to (a.3) to be a business other than an active business.

deemed year end. The adoption of such an approach would presumably also involve the introduction of corresponding changes to the Act which would permit a business to be an active business for part of a taxation year.

(ii) The previous proposals did not have any effect in the context of a Passive Business, or an activity that constitutes a source of income from property under general principles, which gives rise to income from an active business. The February 27, 2004 changes deal with this issue when there is a change from an investment business to an active business but not in the reverse. For example, under the current proposals if a taxpayer had deemed active business income under paragraph 95(2)(a) and that business changed to an investment business the rules in paragraph 95(2)(k.1) do not apply.

Recommendation:

Accrued income and gains on such excluded property at the time that such property ceases to be excluded property should also be reflected for FAPI and surplus computation purposes as active income and gains.

(iii) Proposed paragraph 95(2)(k.1) would not apply in the context of a "taxable Canadian business". The reason for this exclusion is not clear. A taxable Canadian business could also be an active business or a business other than an active business. If a taxable Canadian business was an active business and then became a business other than an active business, it seems that the income or gains accruing during the active period should benefit from the paragraph 95(2)(k.1) changes.

Recommendation:

Proposed paragraph 95(2)(k) should be revised to delete subparagraph 95(2)(k)(ii).

(iv) The recent changes provide no means for releasing the surplus balances if the shares are sold rather than the property to which the rules applied.

Recommendation:

Provide for a release of the surplus if the shares are sold. Note that in effect this will occur with the FAPI if shares are not excluded property when they are sold.

(v) The recent changes should be integrated with other changes in the proposals and to ensure that if the company is merged or liquidated that the deferred income carries over after the reorganization.

Recommendation:

Provide a substituted share rule.

(vi) The recent changes are not integrated in the computation of income or loss and capital gains or losses. It appears that the changes in paragraphs 95(2)(f.1) through to (f.94) that deal with the computation of income when a corporation becomes a foreign affiliate should similarly apply to the fresh start rules. For example, nothing in the fresh start rules deems the foreign affiliate to be a resident of Canada for purposes of computing income (*e.g.*, paragraph 20(1)(n) reserve requires that the taxpayer is a resident of Canada under subsection 20(8)).

Recommendation:

Consider integrating the changes in paragraph 95(2)(f) in computing income or capital gains.

(vii) A similar provision should be enacted to deal with resource properties.

(viii) There is no rule to deal with ceasing to carry on a business. If this rule is necessary in paragraph 95(2)(k.2) then presumably it should also be necessary in paragraph 95(2)(k) such that deferred income under paragraph 95(2)(k.1) is released.

(ix) What ensures that the deferred gain for paragraph 95(2)(k.1) is included in exempt earnings rather than taxable surplus? If at that time the entity is carrying on an investment business and the amount must be income in computing the FA's income what is deeming this to be active business income?

(x) Subparagraph 95(2)(k.1)(iv) appears to be deferring any active income, arising on the passive to active transition due to deemed dispositions, to the time of actual disposition. Reg 5907(2.9), however, appears to be picking the gains up in surplus at the time of deemed disposition. Reg 5907(2.91) only says that the deemed transaction amounts are to be used in the Regulations. It does not appear to change the timing.

We understand that the timing of recognition was amended in the law but did not amend the regulations by oversight. The timing of recognition (deferred to the time of disposition other than the deemed disposition) of the income gain or loss in Reg 5907(2.9) should be the same as that in paragraph 95(2)(k.1). We understand the income will maintain its character as active business income.

(b) Accrued Passive Income and Gains

The introduction of proposed paragraphs 95(2)(k.2) and (k.3) substantially changes the scope and object of the fresh start rules. We have several comments/concerns.

(i) To achieve taxpayer equity and to avoid imposing retroactive changes in policy and legislation, we suggest that the effective date for the implementation of paragraphs 95(2)(k.2) and (k.3) should be extended to specified taxation years commencing in 2006 and preceding taxation years commencing in 2005. Under this proposal, taxpayers would have the balance of 2003 and all of 2004 (*i.e.*, approximately 18 months) to restructure investment businesses into active businesses without being subject to the new "change in use" FAPI rules. At a minimum, paragraphs 95(2)(k.2) and (k.3) should not apply prior to December 20, 2002, even if a Fresh Start Election is made.

(ii) In addition, to ensure that a taxpayer is not subject to tax retroactively, exposed to premature taxation, subject to potential double-taxation without relief, and exposed to tax on an economic loss, we make the following recommendations with respect to the proposed amendments in paragraphs 95(2)(k.2) and (k.3):

1. The proposed amendments should be revised to limit the amount of FAPI to be reported in such circumstances to the lesser of:

   (a) the income or gain that accrued during the period that the affiliate was not carrying on an active business; and

   (b) a portion of the income or gain actually realized on the ultimate disposition of the relevant property, determined as a function of the period during which the affiliate was carrying on an active business and the period during which the affiliate was carrying on a Passive Business.[3]

2. The proposed amendments should be revised to accommodate business issues that are relevant for start-up companies and new ventures and that directly impact the international competitiveness of these companies. Specifically, the Committee recommends that a grace period be introduced for newly formed affiliates, start-up operations and post-acquisition restructuring, so that paragraph 95(2)(k.3) would not apply in respect of businesses which become active within the first 3 years of their commencement or within the

[3] The approach could draw on the legislation currently in place for determining the principal residence deduction.

first 3 years of the affiliate becoming a foreign affiliate of the relevant taxpayer.

3. The proposed fresh start rules should also provide a grace period for businesses that are temporarily suspended, to ensure that no FAPI gains or losses are triggered on the subsequent re-start-up of business activities.

4. Unlike the changes in paragraph 95(2)(k.1), the changes in paragraph 95(2)(k.3) require that the taxpayer elect to defer the income, loss or gain. Because of the complexity of making this determination, it would seem to make more sense for the deferral to be the default rule. Reg 5918 election due date for election is due date of return of taxpayer for the specified taxation year. The information required to make this election may not be available by that date especially if the foreign returns are due after the filing of the Canadian return.

5. The FAPI is deemed to arise at the end of the preceding year unless an election is filed. As a result, the inclusion in income will be late if the change occurs in the specified taxation year and after the preceding years tax return is filed.

6. The reference in subparagraph 95(2)(k.3)(iii) to

> "each property that is deemed…to have been disposed of in the *specified taxation year*"

should be to the year before the specified taxation year.

7. The rules in Reg 5907(2.91) deem property sold in the same manner and for the same amounts as in paragraphs 95(2)(k.1) and (k.3). However, the provision is not clear in how it deals with amounts deferred under paragraphs 95(2)(k.1) or (k.3). It is not clear whether the deferred income under paragraph 95(2)(k.1) should be included in exempt earnings rather than taxable surplus and when this amount is to be included.

8. In a circumstance where the new fresh start rules apply to the change from a passive to an active business, any FAPI realized pursuant to paragraph 95(2)(k.3) may be deferred pursuant to subparagraph 95(2)(k.3)(iii). However, the deferred FAPI will be triggered upon any disposition of the particular property, rather than merely upon an external disposition. Even though the property remains within the affiliate group, it would appear that an internal transfer of the particular property on which there is deferred FAPI will be triggered at the time of any transfer. It is understood that the deferral was allowed to enable a proper

matching of FAPI to foreign tax which would be paid on an ultimate disposition. In many cases internal transfers will not give rise to foreign tax. It is recommended that the deferred FAPI be triggered upon an external transfer or upon election by the taxpayer (*i.e.*, if an internal transfer resulted in foreign tax).

23. FOREIGN EXCHANGE ISSUES[4]

The February 27, 2004 draft legislation include a number of amendments intended to address concerns that arise in connection with foreign exchange fluctuations and arrangements entered into by affiliates to hedge their exposures in this regard. These amendments are summarized as follows.

(i) Proposed subparagraph 95(2)(a)(vi) applies to include in an affiliate's income from an active business the income or loss derived by it under or as a result of certain agreements hedging paragraph 95(2)(a) active income (corresponding amendments will also be made to the Regulations).

(ii) The definition of "excluded property" in subsection 95(1) is expanded to include new paragraph (c.1), which includes any property arising under or as a result of certain agreements hedging foreign exchange risks on receivables arising on the disposition of excluded property, or in respect of receivables generating paragraph 95(2)(a) active income.

(iii) Proposed paragraph 95(2)(g.01) deems to be *nil* any income, loss, capital gain or capital loss, derived by an affiliate under or as a result of certain agreements hedging foreign exchange risks arising in respect of property described in paragraph 95(2)(g), and corresponding to income, loss, capital gain or capital loss deemed to be *nil* under that paragraph.

(iv) Two new supporting provisions are also introduced. Paragraph 95(2)(g.02) applies to isolate and allocate foreign exchange gains and losses between excluded property and non-excluded property. Paragraph 95(2)(i) deems any gain or loss of an affiliate to be from the disposition of excluded property determined in accordance with subsection 39(2) if the gain or loss is derived from the settlement or extinguishment of a debt, all or substantially all of the proceeds from which were used at all times to acquire excluded property, or to earn income from an active business, or if the gain or loss is derived under or as a result of an agreement hedging foreign exchange risk, with respect to such a debt.

(a) Committee's Concerns with these amendments

Concerns common to these amendments are as follows.

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[4] This section includes excerpts from our Submission dated September 18, 2003.

(i) Proposed subparagraph 95(2)(a)(vi) applies only in respect of the income or loss derived by an affiliate under or as a result of an agreement that provides for the "purchase, sale or exchange of currency". The same is true of each of the proposals referred to above (except proposed paragraph 95(2)(g.02)). Thus, it would not apply to foreign exchange and other arrangements structured other than as agreements that provide for the purchase, sale or exchange of currency.

(ii) In addition, proposed subparagraph 95(2)(a)(vi) appears to apply only in respect of hedges of receivables, not in respect of hedges of payables. The same is true with respect to the proposals relating to the definition of excluded property. However, the active business income or loss of an affiliate would be determined as a function of both its revenues reflected in receivables and its expenses reflected in payables. Accordingly, in the absence of a change, such payments will be FAPL.

(iii) Moreover, as currently drafted, proposed subparagraph 95(2)(a)(vi) refers to an agreement made by an affiliate "to reduce its risk, with respect to an amount …, of fluctuations in the value of the currency in which the amount was denominated". This essentially is true of each of the proposals referred to above (except proposed paragraph 95(2)(g.02)). This language suggests that the affiliate's risk may arise relative to any other currency, which is appropriate. For example, an affiliate may desire to hedge its exposure to foreign exchange fluctuations between the currency in which a loan it has made is denominated, on the one hand, and the currency in which a loan it has taken out (in order to fund the loan it has made) is denominated, on the other hand. Similarly, a foreign affiliate may, for reasons of corporate policy, desire to hedge its foreign exchange exposure back into Canadian dollars, which would not be inappropriate, given the context of having a relevant taxpayer resident in Canada.

(iv) Finally, these proposals would not appear to cover hedging arrangements intended to cover the risk of fluctuations in interest rates (*i.e.*, interest rate swap agreements, etc).

Recommendation:

The proposed amendments should be revised as follows to address these concerns.

(i) The scope of these provisions should be broader to encompass other types of hedging arrangements, which may not be structured in the form of agreements that provide for the purchase, sale or exchange of currency, by using language along the lines of that in paragraph 95(2.1)(b).

(ii) The scope of certain of these provisions should be broader to also encompass hedging arrangements which relate to foreign exchange risk to

which an affiliate is exposed in respect of payables which are relevant in computing its income or loss from an active business.

(b) Hedges and the definition of excluded property

Proposed paragraph (c.1) of the definition of "excluded property" in subsection 95(1) includes any property arising under or as a result of an agreement that provides for the purchase, sale or exchange of currency, and can reasonably be considered to have been made by an affiliate to reduce its risk of fluctuations in the value of the currency in which an amount receivable was denominated, where the amount was receivable under an agreement that relates to the sale of excluded property or the amount receivable was a property described in paragraph (c) of the definition of "excluded property".

We believe that the proposed amendments in this area should be revised to address the following concerns.

(i) This provision should address a situation where an affiliate has entered into an agreement to hedge the future sale of excluded property such that a foreign exchange fluctuation that reduces the value of the future receivable would give rise to a corresponding entitlement under a hedge of that receivable. Absent this provision, the affiliate may realize a FAPI gain on closing out its position under that hedge.[5]

(ii) We believe that it is appropriate for the definition of excluded property be expanded to make it clear that where, to reduce its foreign currency risk in respect of an excluded property or in respect of gains/losses on loans that are deemed to be gains/losses of excluded property, a foreign affiliate enters into a hedge with another foreign affiliate in which the taxpayer has a qualifying interest, the hedge would be excluded property to the other affiliate.[6]

(iii) Arguably, some provision should be made for the value of positions under hedges of income streams from property described in paragraph (c) of the definition of "excluded property" (*i.e.*, hedges described in proposed subparagraph 95(2)(a)(vi)), and this may be what this language alludes to. On the other hand, property arising under or as a result of such hedges may already be excluded property under paragraph (c), because all income

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5 While the Explanatory Notes explain that the proposal change is intended to deal with the hedging of a receivable with respect to the sale of excluded property, the concern expressed above is where, although the affiliate has an obligation to sell excluded property, no amount is actually "receivable" when the hedge is entered into.

6 The other affiliate may perform this role as an intermediary between the affiliate and a third party financial institution in order for third party hedges of the worldwide group to be centrally controlled and managed rather than having individual affiliates responsible for arranging their own hedges with the third party financial institution.

received from that property would be included in active business income under proposed subparagraph 95(2)(a)(vi).

(iv) Some provision should also be made with respect to the value of positions under hedges of the capital element of property other than receivables described in paragraph (c), for example hedges relating to excluded property that is intangible property.

Recommendations:

This provision should be clarified so as to refer to an agreement made by the affiliate to reduce its risk with respect to:

(i) an amount that was, or that could reasonably be expected to become, receivable in respect of a property described in paragraph (c);

(ii) an amount reflecting the value, determined in a foreign currency, of a property that is excluded property under paragraph (a) - (c);

(iii) an amount that was, or that could reasonably be expected to become, payable and that could reasonably be considered to be deductible in computing the affiliate's income from an active business in accordance with paragraph 95(2)(a); and,

(iv) an amount that was, or that could reasonably be expected to become, receivable or payable, as the case may be, in respect of the disposition or acquisition, as the case may be, of excluded property.

(c) Isolating and allocating foreign exchange fluctuations

As noted above, two new supporting provisions apply to isolate and allocate foreign exchange fluctuations between excluded property and non-excluded property. Proposed paragraph 95(2)(g.02) applies to provide that, in applying subsection 39(2) for the purpose of subdivision i, the gains and losses of a foreign affiliate of a taxpayer in respect of excluded property must be computed in respect of the taxpayer separately from the gains and losses of the affiliate in respect of property that is not excluded property. This measure is appropriate because subsection 39(2) aggregates all foreign exchange gains and losses realized in a particular year and then deems a capital gain or loss only to the extent of any net gain or loss, without regard to the source of particular gains and losses.

In addition, proposed paragraph 95(2)(i) applies to achieve two allocation functions. First, subparagraph 95(2)(i)(i) would deem any gain or loss of an affiliate, determined in accordance with subsection 39(2), to be a gain or loss, as the case may be, from the disposition of an excluded property if the gain or loss is derived from the settlement or extinguishment of a debt, all or substantially all of the proceeds from which were used at all times to acquire excluded property or to earn income from an active business or for a combination of those uses. This

proposed amendment expands the scope of current paragraph 95(2)(i) in certain respects. The current rule requires the indebtedness to have related at all times to the acquisition of excluded property. Thus, there is no "all or substantially all" threshold, so minor "misuses" disqualify the entire debt. Moreover, the current rule does not apply to debt used to finance obligations arising in the course of an active business, other than with respect to the acquisition of excluded property, such as debt used to finance payments for services.

Similarly, subparagraph 95(2)(i)(ii) deems any gain or loss of an affiliate determined in accordance with subsection 39(2) to be a gain or loss, as the case may be, from the disposition of an excluded property if the gain or loss is derived under or as a result of an agreement that provides for the purchase, sale or exchange of currency, and that can reasonably be considered to have been made by the affiliate to reduce its risk, with respect to a debt referred to in subparagraph (i), of fluctuations in the value of the currency in which the debt was denominated. Accordingly, both foreign exchange gains and losses derived from the settlement or extinguishment of a qualifying debt and any such gains or losses under or as a result of a related hedge, will be deemed to be from the disposition of an excluded property. Therefore, the amount of any such gains or losses would generally have to be computed in the calculating currency of the relevant affiliate, pursuant to subparagraph 95(2)(f)(ii).

We are concerned that, as currently drafted, this provision would be too narrow. In particular, we are concerned that the reference to subsection 39(2) may not be appropriate in the context of a gain or loss arising in respect of a hedge, particularly where the hedge is structured as an agreement which provides for the purchase of currency. In that context, the relevant taxpayer's gain may well be a gain which arises under subsection 39(1), on the basis that the taxpayer's cost of the currency will be determined as a function of consideration given for that currency under the agreement (*i.e.*, the spot price for the currency in which payment is made by the taxpayer) and the taxpayer could then have a gain or loss on the subsequent disposition of that currency, depending on its fair market value at the time of disposition relative to that cost.

In addition, proposed subparagraph 95(2)(i)(i), as currently drafted, applies only where the "proceeds" of the relevant debt were "used" for certain purposes. This language could be interpreted to exclude a balance of sale arising in respect of the acquisition of excluded property or in respect of expenditures made or incurred for the purpose of earning income from an active business, and debt which was assumed in connection with the acquisition of excluded property. We assume that such an exclusion is not intended.

Recommendations:

Subparagraph 95(2)(i) should be modified in the following respects:

(i) the reference to subsection 39(2) should be deleted;

(ii) the wording should be modified so that for greater certainty the provision applies to gains and losses on income account; and

(iii) both loans and other debts should clearly be covered.

(d) Hedging Active Income Streams

As noted above, proposed subparagraph 95(2)(a)(vi) applies to include in an affiliate's income from an active business the income or loss derived by it under or as a result of an agreement that provides for the purchase, sale or exchange of currency and that can reasonably be considered to have been made by the affiliate to reduce its risk relating to foreign exchange fluctuations with respect to amounts required to be included in computing its income or loss from an active business under paragraph 95(2)(a).

Proposed clause (d)(ii)(M) of the definition of "exempt earnings" in Reg 5907(1) provides the conditions when such gains and losses are to be included in an affiliate's exempt earnings. We recommend that this provision be simplified and altered so that the surplus treatment of the such gains and losses be similar to the surplus treatment of the related amounts included in computing the affiliates income or loss from an active business under paragraph 95(2)(a).

(e) Foreign Exchange Fluctuations on an Accrual Basis

Proposed subparagraph 95(2)(a)(v) ensures that the income or loss derived by a foreign affiliate from the *disposition* of excluded property that is not capital property will not give rise to FAPI. This provision is relevant in circumstances where an affiliate carries on an investment business but it owns property that (i) earn income from an active business under paragraph 95(2)(a) and (ii) any gain or loss from the disposition of such property would not be a capital gain or loss (for example, eligible capital property and in certain situations, loans to other affiliates).

This provision should be modified to ensure for greater certainty that it deals with situations where it is appropriate or required to mark-to-market the property (for example, for foreign exchange fluctuations) but there is no actual or deemed *disposition* of the property.

Further, because a gain or loss could arise on a disposition of such assets to a third party (for example, the sale of an intangible that is eligible capital property), proposed clauses (d)(ii)(L) and (c)(ii)(L) of the definition of "exempt earnings" and "exempt loss", respectively, should be revised accordingly.

***Recommendations*:**

To address the above concerns, the following revisions should be made to the proposals.

(i) Definition of "Qualifying Hedge"

To address a number of the above concerns, we recommend that a new definition be included in subsection 95(1) as follows:

> "qualifying hedge" means an agreement which is or is similar to a currency or interest rate swap agreement, a forward purchase or sale agreement, a forward rate agreement, a futures agreement, an option agreement or a rights agreement (herein referred to as a "contract"), that can reasonably be considered to have been made by a foreign affiliate to modify its risk or opportunity, with respect to an amount that
>
> (a) was or was expected to be or become receivable or payable under an agreement that relates to the acquisition, development, holding or disposition of excluded property, or that relates to the financing of the acquisition, development, holding or disposition of excluded property,
>
> (b) was or was expected to be or become
>
> (A) receivable in respect of excluded property or otherwise in respect of an amount that would be required to be included in computing the affiliate's income or loss from an active business, or
>
> (B) payable in respect of excluded property or otherwise in respect of an amount that would be deductible in computing the affiliate's income or loss from an active business, or
>
> (c) reflects or was expected to reflect the present or future fair market value of excluded property,
>
> in relation to fluctuations in the value of the currency in which the amount was denominated relative to any other currency, or in relation to fluctuations in the difference between the rate at which the amount was calculated and any other rate, and,
>
> (d) where a particular foreign affiliate enters into a contract with another foreign affiliate of the taxpayer in which the taxpayer has a qualifying interest, or a partnership of which the particular affiliate or the other affiliate is a qualifying member, throughout the year, where the contract is a qualifying hedge to the other

affiliate or partnership, the contract is deemed to be a qualifying hedge to the particular affiliate, and

(e) where a particular foreign affiliate enters into a contract in respect of a risk of another foreign affiliate of the taxpayer in which the taxpayer has a qualifying interest, or a partnership of which the particular affiliate or the other affiliate is a qualifying member, throughout the year, where the contract would be qualifying hedge to the other affiliate or partnership if it were entered into by it, the contract is deemed to be a qualifying hedge to the particular affiliate,

(ii) The following related revisions would be necessary:

Excluded Property:

(c.1) property arising under or as a result of a qualifying hedge

95(2)(a)(vi):

(vi) the income or loss is derived by the particular foreign affiliate under or as a result of a qualifying hedge;

95(2)(g.01):

(g.01) any income, loss, capital gain or capital loss, derived by a foreign affiliate of a taxpayer under or as a result of a qualifying hedge (with respect to a property, obligation, share or other security of or issued by the particular affiliate, or another affiliate of the taxpayer in which the taxpayer has a qualifying interest, any particular income, gain or loss determined in reference to which is deemed by paragraph (g) to be nil) is, to the extent of the absolute value of the particular income, gain or loss, deemed to be nil;

(iii) Paragraph 95(2)(i) should be revised as follows:

Any capital gain, taxable capital gain, capital loss or allowable capital loss, as the case may be, of a foreign affiliate of a taxpayer is deemed to be a capital gain, taxable capital gain, capital loss or allowable capital loss, as the case may be, from the disposition of an excluded property, and any income or loss of a foreign affiliate of a taxpayer is deemed to be income or loss from the disposition of excluded property which is not capital property, if it is derived

(i) from the settlement or extinguishment of a debt, or by virtue of the fluctuation in value of a debt, all or substantially all of which arose from or in relation to the acquisition of excluded property or

> all or substantially all of the proceeds from which were used at all or substantially all times to acquire excluded property or to earn income from an active business or for a combination of those uses and
>
> (ii) under or as a result of a qualifying hedge with respect to a debt referred to in subparagraph (i)

(iv) Proposed clause (d)(ii)(M) of the definition of "exempt earnings" in Reg 5907(1) should be modified as follows:

> amounts required to be included in computing the particular affiliate's income for the year from an active business because of subparagraph 95(2)(a)(vi) to the extent that such amounts can reasonably be considered to relate to amounts which are included or deducted in computing the particular affiliate's exempt earnings or exempt loss in respect of the corporation.[7]

(v) Proposed subparagraph 95(2)(a)(ii)(v) should be revised as follows:

> (v) the income or loss is derived by the particular foreign affiliate from the disposition of, or by reason of a fluctuation in the value of, excluded property that is not capital property, or

(vi) Proposed clauses (d)(ii)(L) and (c)(ii)(L) of the definition of "exempt earnings" and "exempt loss" should be modified along the same lines as suggested in (iv) immediately above.

24. MISCELLANEOUS FOREIGN EXCHANGE

Subsection 93(2) – The proposed changes should be extended to apply to where foreign exchange gains realized by a taxpayer resident in Canada reasonably relate to losses incurred by a related Canadian taxpayer. For example, in a situation where Canco 1 borrows in a foreign currency to capitalize a wholly-owned subsidiary, Canco 2, which uses the funds to invest in a foreign affiliate.

In addition, the proposed changes should be clarified to deal with situations where foreign exchange gains arising in a particular year or years will apply to reduce the loss disallowance where the loss arises in a different year or years.

The provision requires a settlement or extinguishment of the obligation of the corporation. It is not clear that a partial payment of the debt resulting in a foreign exchange gain qualifies for the relief.

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[7] A corresponding modification would also be required in the wording of proposed clause (c)(ii)(M) of the definition of "exempt loss" in Reg 5907(1).

Should the changes apply in circumstances where the offsetting gain is on the debt or shares of another foreign affiliate that is deemed nil under paragraph 95(2)(g)?

25. PARTNERSHIPS

(a) There is a need to clarify the comprehensiveness of the transparency of partnerships as contemplated in section 93.1 for the purposes of determining FAPI and surplus of foreign affiliates.

(b) The proposed rules do not adequately address partnership reorganizations. For example, excluded property (*i.e.*, real estate) may be distributed from a partnership to the partners. Such distribution could cause the dissolution of the partnership, unless some property (*i.e.*, working capital) remains in the partnership.

It does not appear that there are any "rollover" rules for liquidations or distributions from partnerships as there are for foreign affiliates.

It appears that, on the distribution from the partnership:

(i) paragraph 95(2)(f.3) applies so the consequences in (f.4) will apply;

(ii) proceeds to the partnership is deemed to be ACB of the assets distributed;

(iii) cost to the partners is deemed to be FMV; and

(iv) there would be suspended income/gain in the partners in respect of the partnership.

There appears to be no earnings and therefore no increase to partnership ACB per Reg 5907(12). In such case, the partners will have a capital gain on the disposition of the partnership interest. If this disposition is to a specified purchaser (*i.e.*, the partnership), it appears that paragraph 95(2)(f.4) applies again at the partner level. This assumes that the partnership interest is excluded property (*i.e.*, measured immediately before the distribution of the real estate which causes the dissolution of the partnership and the disposition of the partnership interest). If so, this result seems to work to suspend the property level gain and the gain on the partnership interest.

If the partnership is not dissolved, it is assumed that the ACB of the partnership interest is reduced by the FMV of the property distributed (Reg 5907(12)(b)(iv)). If that reduction drives the ACB negative, there does not appear to be anything which crystallizes the gain, since it does not appear that subsection 40(3) applies. If subsection 40(3) applies, there is nothing in the new rules to "reduce" the gain otherwise arising in a manner similar to subsection 40(3) gains on shares.

In addition, the concern is that the partnership interest is no longer excluded property if the sole piece of real estate is distributed (*i.e.*, no real estate left, only

some working capital which would not support 6 full time employees). This concern is also present if the real estate is sold for cash, so cash is the sole asset of the partnership at that time.

We understand the Department is considering extensive rules to deal with partnerships.

26. CONTINUATION

Reg 5907(13) applies when a foreign affiliate continues into Canada and has a taxable surplus balance. The amendment to Reg 5907(13)(a) is appropriate. It reduces taxable surplus by the amount of foreign tax that would have applied to the deemed disposition of property if the disposition had been an actual disposition. This allows the calculation to work properly, as described in the Submission of September 18, 2003 and the CRA technical interpretation letter. New Reg 5907(14), appears intended to provide that this notional foreign tax shall be deemed to be nil if an actual disposition would not have resulted in taxation in any country other than Canada.

For example: Canco owns FA1 that owns FA2, both resident in the U.S. FA1 continues into Canada and is deemed to dispose of the shares of FA2 for Canadian tax purposes. The continuation is a non-event for US tax purposes. The FA2 shares are excluded property and the disposition creates exempt surplus and taxable surplus. Reg 5907(13) requires the taxable surplus to be picked up as FAPI unless there is sufficient foreign tax to offset it. The underlying foreign tax in this respect includes notional foreign taxes – the U.S. tax that would have been paid by FA1 if it had sold FA2. New Reg 5907(14) is apparently intended to provide that no notional taxes will be considered to arise if the U.S. would not have had the right to tax the gain if the deemed disposition had been an actual disposition. The wording does not seem to accomplish this. It is unclear whether the reference to "had the taxpayer realized a gain" should be "had the affiliate realized a gain"; also whether the test should apply after the continuation – *i.e.*, if FA1 sold FA2 after FA1 continued to Canada would the US be able to tax the gain?

Prior to the announcement of the intention to amend the *Canada-US Treaty* in this respect, FA1 could sell FA2 and claim a treaty exemption from U.S. taxation on the basis that FA1 had become a resident of Canada for treaty purposes. There would be no Canadian gain due to the increase in basis of the FA2 shares due to the deemed disposition on the continuation.

In this example, if new Reg 5907(14) works as Finance intends, it would result in no notional underlying foreign taxes being available to offset the FAPI inclusion, since the U.S. would have the right to tax an actual disposition of the FA2 shares by FA1 until the moment FA1 continued to Canada, and the deemed disposition takes place prior to the continuation.

***Recommendation*:**

The application of proposed Regulation 5907(14) should be clarified with respect to the actual disposition referred to in the provision: what is the identity of the vendor (the

taxpayer or the affiliate that has continued to Canada) and at what point in time is the actual disposition to have occurred for the purpose of determining if tax would have been payable to a country other than Canada.

27. COMING INTO FORCE

(a) There is substantial administrative burden associated with examining the questions associated with making the elections. For example, a taxpayer likely will have issues in the last few years but not necessarily back to 1994. The taxpayer may have to incur significant expense to determine all of the implications of making the election in relation to all of its affiliates for all years back to 1994 – almost 10 years. Those who choose to do so should be permitted, but those who prefer not to examine all years should still be permitted to choose a smaller number of years to examine.

Recommendation:

Taxpayers should be permitted to make elections retroactively as of a certain year, but not necessarily 1994, if they so choose – as long as all years going forward are covered, a form of "elective partial retroactivity".

(b) Currently, proposed revisions to Reg 5907(2.8) and proposed Reg 5907(2.81) to (2.83) will apply to taxation years of a foreign affiliate of a taxpayer to which the changes to subclauses 95(2)(a)(ii)(D)(III) to (V) apply. Accordingly, if the taxpayer elects to apply the changes to subclauses 95(2)(a)(ii)(D)(III) to (V) retroactively, these regulations will also apply on a retroactive basis. Under such circumstances, the taxpayer would be required to re-compute surplus balances pursuant to Reg 5907(2.8) to (2.83) for those prior tax years, which could be for as many as 10 tax years. This would impose a significant burden on taxpayers. In addition, changes to the surplus balances could in turn adversely affect previously filed subsection 93(1) elections, previous dividend payments and ACB and FAPI calculations.

Recommendation:

The revisions to Reg 5907(2.8) and proposed Reg 5907(2.81) to (2.83) should be applicable only for taxation years beginning after December 20, 2002.

28. MISCELLANEOUS

(a) Delete internal sale rule re pre-76 gains from "exempt earnings".

(b) Although not part of the February 2004 amendments, if an LLC is owned directly by a Canadian, there is an inability to characterize foreign tax paid by the Canadian member/shareholder in respect of the LLC's income as, for example, foreign accrual tax. There would not appear to be any mischief to enable such tax paid by the Canadian member/shareholder to qualify as such. An amendment

should be made such that the Canadian member/shareholder is not subject to additional tax merely because of the flow-through nature of the LLC.

(c) Conflict between subsection 88(3), paragraph 95(2)(e), (e.3), etc. and paragraph 95(2)(h.1).

(d) Changes to carryforward for deductible loss to 7 years from 5 in Reg 5903. No corresponding change in subsection 91(4) to carry forward for foreign accrual tax. Not clear from a policy perspective whether this should be extended to 7 but given differences in foreign law for the carry forward of losses and the computation of income, it seems these should be consistent.

(e) Timing for various elections by due date of return with no provisions for amending or revoking. In many cases, will not have finalized foreign tax returns or have information necessary to make determination.

29. MISCELLANEOUS – EXPLANATORY NOTES

(a) Note apparent error in technical notes to paragraph 95(2)(f.3) to (f.9). Reference should be to Reg 5917 not Reg 5916.

(b) Note apparent error in technical notes to subsection 95(2.21). New subsection 95(2.21) is not included in the Global s.95 Election.

(c) Note apparent error in technical notes. Subsection 95(3.8) applies after Feb. 27, 2004 not after Dec. 20, 2002.

(d) Note apparent error in technical notes (p. 817). The "taxable earnings" amendment is not subject to Global s.95 Election.

(e) Note apparent error on p. 810 of technical notes where Qualifying Member Amendments should be reference to "exempt earnings" not "exempt surplus." Also, the comments on pp. 812-813 appear to be somewhat misleading since although correct that the Qualifying Member Amendments apply to tax years that end after 1999 if the Global s.95 Election is made, a modified version of the affected provisions will in that event apply after 1994 (see p. 431).

(f) Note apparent error in technical notes (p. 844), Reg 5916 does not set out requirements for election under subsection 88(3), 5919 does so.