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

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May 3, 2010

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

Dear Mr. Ernewein

Re: Budget 2010 – March 4, 2010 Notice of Ways and Means Motion to amend the Income Tax Act and Income Tax Regulations

Enclosed is our submission on the income tax measures announced in the Budget on March 4, 2010 and detailed in the accompanying Notice of Ways and Means Motion to amend the Income Tax Act and Income Tax Regulations (the "Budget 2010 Proposals") and Bill C-9 where applicable.

In our submission, we provide our views and recommendations on the following topics:

- Employee stock options proposals
- Amendments to the definition of Taxable Canadian Property
- Foreign tax credit measures
- Interest on overpaid taxes

We have also sent to you today, under separate cover, our comments and observations on the Non-Resident Trust and Foreign Investment Entity measures announced in the Budget 2010 Proposals.

As always, we appreciate the opportunity to submit our views on these proposed amendments. We trust you will find our comments and recommendations helpful. We invite you to speak to either one of us if you have any questions or require elaboration on any of the matters discussed in the enclosed. As well, we would be pleased to meet with you and your officials to discuss our submission.

Yours truly,

D. Bruce Ball
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Elaine Marchand
Chair, Taxation Section
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**Submission of the
Joint Committee on Taxation of The Canadian Bar Association
and The Canadian Institute of Chartered Accountants**

**Budget 2010 – March 4, 2010 Notice of Ways and Means Motion to
amend the Income Tax Act and Income Tax Regulations**

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INTRODUCTION

This submission sets out our comments and recommendation on certain of the income tax measures announced in the March 4, 2010 Federal Budget and Annex 5 – Tax Measures: Supplementary Information and Notice of Ways and Means Motions (the "**Budget Proposals**").

Unless otherwise noted, references to sections, subsections, paragraphs, etc. are to the provisions of the *Income Tax Act* (Canada)(the "**Act**") and references to "**Resolutions**" are to the corresponding paragraphs of the Notice and Ways and Means Motion to the *Income Tax Act* and *Income Tax Regulations* included in the Budget Proposals.

1. Employee Stock Options – Resolutions 23 to 31

Stock option cash outs

Resolution 23 proposes to require, as a condition of eligibility for the deduction currently available under paragraphs 110(1)(d) and (d.1)[1] that the securities described in an agreement to sell or issue shares referred to in subsection 7(1) be acquired by the employee, unless the employer elects in respect of all stock options issued under the agreement that neither the employer nor any person not dealing at arm's length with the employer will deduct any amount in respect of a payment to or for the benefit of the employee for the employee's disposition of rights under the agreement.

This additional condition is stated to apply for *transactions occurring after 4pm EST on March 4, 2010*. Paragraph (a) of Resolution 23 also states that the deduction to the employee will be available if the employer elects in prescribed form *in respect of all options issued or to be issued after 4pm EST on March 4, 2010 under the agreement*. However, we understand that Resolution 23 is intended to apply to the cash settlement of an option (whenever granted) that occurs after 4pm EST on March 4, 2010, and that the election referred to in paragraph (a) of Resolution 23 may be made in respect of all options under a particular award (regardless of the date of grant) to a particular employee (i.e. the election is on an agreement per agreement basis). We suggest that the legislation giving effect to Resolution 23 clarify that the election applies on a grant by grant basis; alternatively, this should be confirmed in the explanatory notes accompanying the draft legislation.

We are concerned by the immediate application of Resolution 23 and the absence of grandfathering provisions. Indeed, by virtue of its application to all outstanding stock options, or existing agreements providing for cash settlement of stock option rights, Resolution 23 compromises settled commercial relationships. The availability of the 110(1)(d) deduction to the employee and a deduction to the employer in respect of cash settled options is long

[1] We note that Resolution 23 purports to apply to the deduction under paragraph 110(1)(d.1). Given that the deduction provided under that paragraph is only available if the optioned shares are acquired and held for two years, we assume that the reference to paragraph 110(1)(d.1) is unintended.

standing. This Budget measure, included among the measures to "close tax loopholes", does not have the colour of aggressive tax positions that, in other circumstances, have justified immediate application of amendments that preclude taxpayers from receiving the expected tax benefit. Arm's length parties that have agreed to compensation arrangements involving cash settlement of options have done so in good faith; Resolution 23 now forces one of the parties to compromise their position under such arrangements.

The application of Resolution 23 to outstanding options also adversely affects issuers who have hedged their obligations. Option plans that contain cash settlement provisions are treated as cash liabilities for accounting purposes and require mark-to-market valuation each reporting period. Therefore, to reduce financial statement volatility, issuers will hedge their obligations under such plans if they are substantial. It is expected that the effect of Resolution 23 will be that option holders will no longer choose cash settlement if the employer does not make the proposed election, and it appears unlikely that many employers will elect to pay out non-deductible cash settlements. Thus, plan sponsors are left with the choice of either (i) amending the option plan to eliminate the cash settlement option, and unwinding a hedge position at a gain (with no offsetting deduction) or at a loss, and suffering additional dilution, or (ii) maintaining an artificial cash settlement option and continuing to tie up assets in a 'hedge' position.

Moreover, Resolution 23 would apply to signed transaction commitments (mergers and acquisitions, for instance) that include a commitment to cash settle all option rights. The cost of such a commitment (and overall deal pricing) would invariably have been computed by the parties having regard to the deductibility of the payment to the employer.

Recommendation:

We recommend that Resolution 23 apply only to stock option awards made after 4pm on March 4, 2010.

Withholding and Remittance

Resolutions 26 requires employers to withhold and remit tax in respect of an employment benefit under subsection 7(1) to the same extent as if a cash bonus of an equal amount had been paid out to the employee. Resolution 27 removes the Minister of National Revenue's statutory authority to reduce the amount remitted in respect of an employment benefit where the benefit arose from the acquisition of securities.

The transitional relief provided in Resolution 28 makes these withholding and remittance requirements inapplicable in respect of rights under an agreement to sell or issue shares granted before 2011 if the agreement was entered into in writing before the Budget Date and included on the Budget Date, a written condition that restricts the employee from disposing of the securities acquired under the agreement for a period of time.

Public companies often have share ownership policies or requirements for certain executives, and where the executive does not otherwise meet the requirement, companies may require that securities acquired under a share option plan be held to comply with such policies or requirements. The transitional relief provided in Resolution 28 will not capture such situations (i.e. where the share ownership policy is not set out in writing in the option agreement).

Recommendation:

We recommend that the transitional relief in respect of Resolutions 26 and 27 be extended to include other forms of employment conditions or policies that were in effect on March 4, 2010 and that restrict an employee from disposing of shares acquired under options granted before 2011.

2. Section 116 and Taxable Canadian Property – Resolutions 38 to 40

Although the proposed amendment to paragraphs (d) and (e) of the definition of taxable Canadian property ("TCP") are welcomed and appreciated, we believe certain changes would further reduce compliance costs and allow for a freer flow of investment funds. We have identified some potential issues and concerns, and have also set out our recommendations.

Lack of Due Diligence Rules

Although the change to the definition of TCP is relatively straightforward, there can be significant uncertainty when applying these rules in practice, because the 50% fair market value test is measured continuously during the preceding 60-month period ending on the date of determination. In many situations, the purchaser may conclude after reasonable inquiry that the share or interest is not TCP. However, if the share or interest is in fact TCP due to unknown facts or honest disagreements on the valuation of underlying property, then the purchaser can still incur liability under section 116.

Recommendation:

As this concern is very similar to the concerns raised in the past in respect of treaty-protected property, we recommend that the exceptions from liability in subsection 116(5) be expanded such that a purchaser will not incur liability where, after reasonable inquiry, the purchaser had no reason to believe that the property was described in paragraph (d) or (e) of the proposed definition of TCP in section 248.

Application of the 60-Month Rule

Under the proposed amendment to the definition of TCP, unless deemed to be TCP, a share of a corporation or an interest in a partnership or trust will be TCP only where, at any particular time in the 60-month period preceding the determination, more than 50% of the fair market value of the share or interest is derived directly or indirectly from "real property" (real or immovable property situated in Canada, Canadian resource properties, timber resource properties, and options in respect of these properties). We believe that this rule does not adequately address situations where an entity has disposed of real property prior to a disposition of the interests in the entity itself and we question why shares or interests in the entity would continue to be categorized as TCP once the underlying real property has been disposed of. In other countries and in tax treaties, such tests are often applied only at the time of disposition.

Recommendation:

We suggest that the determination of whether a share of a corporation or an interest in a partnership or trust derives its value directly or indirectly from real property for purposes of the TCP definition should be made at the time of the disposition only, in a manner similar to the approach taken in some of Canada's tax treaties and by other countries.

If, contrary to our suggestion above, the 50% test is not applied at the time of the disposition only, we submit that the TCP amendments should address the following specific issues.

Lack of an Ownership Rule

Unlike proposed paragraph (e) of the definition of TCP, the 50% test in proposed paragraph (d) is not coterminous with the period of ownership of a share or interest by a non-resident.

For example, an inappropriate result under the 60-month look back rule will arise where a non-resident acquires the share or interest after the underlying real property has been disposed of by the corporation, trust or partnership, but before the 60-month period has elapsed. The share or interest would be TCP of the non-resident even though the entity did not hold any real property during the period of the non-resident's ownership. In this situation, if the share or interest were then sold by the non-resident before the 60-month period has elapsed, the purchaser would have to request information relating to a time when the non-resident vendor did not own the property to determine whether the property is TCP.

Recommendation:

The 60-month period referred to in proposed paragraph (d) of the definition of TCP should be limited to the period during which the particular non-resident and persons with whom the non-resident did not deal at arm's length actually owned the property in question.

No Recognition Given to Dispositions of Underlying Real Property

We assume that the policy rationale behind the 60-month look back rule is that if more that 50% of the value of an interest was attributable to real property at any time during the 60 months immediately preceding the disposition, then there is a possibility that more than 50% of the accrued gain on the interest was attributable to real property. However, if underlying real property has been disposed of in a taxable transaction during the 60-month period, the accrued gain on that property has been converted into taxed surplus. The proposed amendment to the definition of TCP does not take this into account.

We note that in the U.S., real property interests held by a corporation during the 5 years prior to a disposition can be effectively ignored when determining whether shares of the corporation are a "United States real property interest" (USRPI) if all real property interests were disposed of in a fully taxable disposition.

Under the USRPI rule, shares of a corporation will not be USRPI at the time of a disposition if that corporation did not hold any USRPIs at that time and throughout the last 5 years. The 5-year rule does not apply provided that all USRPIs were disposed of, or where the USPRI was a share in another corporation, that corporation ceased to be a USRPI.

Recommendation:

We recommend that paragraphs (d) and (e) of the proposed definition of taxable Canadian property be modified so as to recognize fully taxable dispositions of real property during the 60-month period, as is the case in the U.S. That said, we believe such a provision in the Act would have to differ slightly from the U.S. rule since some real property holdings are allowed in Canada (provided that the 50% threshold is not exceeded) without causing the share or interest to be TCP.

We believe that an acceptable and relatively straightforward variation of the U.S. rule would be to recognize dispositions of real property during the 60-month period by allowing the proceeds received for real property in a fully taxable disposition to be substituted for the value of that real property for the purposes of applying the 50% test during the 60-month period preceding the determination. Fully taxable disposition would mean that the entity holding the real property was resident in Canada or in the case of a foreign entity, the disposition of the real property was fully taxable in Canada and in either case, the proceeds in respect of the property were equal to the fair market value of the property.

Alternative approaches to giving recognition for taxable dispositions of underlying real property during the 60-month period preceding the determination are possible, and we would be pleased to discuss these possibilities in more detail with you.

Reorganization Transactions

We have concerns with respect to the continuity rules that apply to certain transactions (referred to here as "reorganization transactions"). For example, under proposed paragraph 85(1)(i), where a property disposed of is TCP of the taxpayer, all of the shares of the capital stock of the Canadian corporation received by the taxpayer as consideration for the property are deemed to be, at any time that is within 60 months after the disposition, TCP of the taxpayer. Our main concern is that the transferred property in question may be shares of a corporation or an interest in a partnership or trust that had already disposed of its underlying real property and this rule would prolong the 60-month period. Worse, the entity in question may have never held real property.

This sort of rule creates two problems. First, for interests held on March 4, 2010, no matter when underlying real property was last held or whether real property was held at all, it would appear that the application of proposed paragraphs (d) or (e) to test TCP status will be delayed for five years where one of the continuity rules was applicable in the past.

Secondly, a reorganization transaction after March 4, 2010 could prolong deemed TCP status another 5 years. For example, if all underlying real property of PreAmalco is sold on January 1, 2011 and the corporation then amalgamates with another corporation (which has never owned real property) on October 31, 2015, then it would appear that the shares of Amalco will continue to be TCP until October 31, 2020.

Recommendation:

Our earlier general recommendation on the 60-month rule would eliminate these issues.

Failing that, we have the following specific suggestions:

1. The 60 month look back provisions that have been proposed should take into account whether underlying real property has been held at all and if so, when it was disposed of.
2. Entities that have undertaken a reorganization transaction before March 4, 2010 should be able to look to the new rules in paragraphs (d) and (e) to determine the TCP status of shares or interests, by considering the time prior to that date to test whether the shares or interests in the entity derived more than 50% of their value from real property. Under this recommendation, if the 50% threshold had not been exceeded during the 60-month period ending on March 4, 2010, then proposed paragraphs (d) or (e) should apply immediately to determine whether the shares or interests are TCP at any time after March 4, 2010. If the threshold had been exceeded during the 60-month period ending on March 4, 2010, then proposed paragraphs (d) and (e) should become applicable to determine whether the shares or interests are TCP (and the continuity rule should cease to apply) at any time after the time when the threshold has not been exceeded for 60 months, including the period before March 4, 2010.

3. Foreign Tax Credit Generators – Resolutions 42 to 44

Overview

The Budget Proposals would deny claims for foreign tax credits (FTC), foreign accrual tax (FAT), and underlying foreign tax (UFT) deductions where a Canadian taxpayer has a lesser direct or indirect entitlement to income or equity interest under foreign tax law in a particular entity than it has under the Act. The measures would apply for tax years ending after March 4, 2010.

To enact these measures, Resolutions 42 to 44 set out three rules:

- *Resolution 42* – Subsection 126(4.11) reduces the foreign taxes available for foreign tax credit claims under section 126 for foreign taxes paid by a partnership in which a taxpayer has a direct interest ("FTC provision").
- *Resolution 43* – Subsection 91(4.1) limits the claim for FAT where the Canadian taxpayer's equity interest in any affiliate in the chain of ownership is less under foreign law than its equity percentage as determined under the Act; a similar limitation applies to partnerships ("FAT provision").
- *Resolution 44* – Regulation 5907(1.03) limits the claim for UFT where the Canadian taxpayer's equity interest in any affiliate in the chain of ownership is less under foreign law than its equity percentage as determined under the Act. A similar limitation applies to a partnership ("UFT Provision").

Below we provide our comments on issues raised by these three provisions and on whether the scope and proposed effective date of the proposals is appropriate for achieving the government's aims.

Scope of Proposals

The "schemes" that the Department of Finance is attempting to curtail are referred to in the Budget Proposals as "foreign tax credit generators". However, this term is not specifically defined and the proposed measures are much broader than the Department of Finance's objectives as stated in the Budget Proposals.

Further, the Budget Proposals suggest that such schemes are complex and generally involve a Canadian corporation making a loan to a corporation in a foreign jurisdiction such that the foreign taxes are based on substance while the Canadian taxes are based on legal form. The Canadian corporation obtains relief for the foreign taxes paid, and the foreign corporate group obtains an offsetting tax reduction. A further characteristic of the schemes that was noted in the Budget Proposals was that the Canadian tax savings are generally shared between the parties. The proposals appear to target certain financial transactions or entities which are characterized differently under Canadian and foreign tax law. Notwithstanding these comments regarding the form and results of the schemes, the proposals are formulaic and make no reference to the type of transaction, motivation or tax results targeted, rather, the proposals focus exclusively on differences in tax ownership of equity interests in either partnerships or corporations. The result, as noted below, are measures that reach far beyond loans made by a Canadian corporation to a foreign entity, encompassing very legitimate business transactions or arrangements and causing double taxation. Additionally, the Budget Proposals suggest the measures are intended to apply to corporations yet they apply to any taxpayer.

Canadian based taxpayers carry on businesses and enter into transactions in a variety of international jurisdictions, in competition with other multi-nationals. Few businesses or transactions would be viable if subject to local taxation at rates approximating Canadian tax rates plus Canadian taxation, unrelieved by direct or indirect foreign tax credits. Thus the direct and indirect foreign tax credits are critical to international competitiveness of Canadian based multinationals and investors. Appropriate design of the tax system and tax policy are important to maintain a level playing field for Canadian based multinationals in comparison to their competitors for international business.

The direct and indirect tax credits play a vital role in this regard in ensuring that relief is given in recognition of local tax already borne by profits from international business and transactions in taxing those profits in Canada, whether as direct income, imputed FAPI or upon repatriation of profits from taxable surplus. The role of foreign tax credits in protecting against double taxation is recognized in Canada's bilateral income tax conventions (as well as the OECD model).

Canadian based multinationals are subject to local taxation in many jurisdictions under many different taxation systems, none of which mirror the Act. Other tax jurisdictions compute partnership income under different rules (and in different currencies). It is not particularly novel that a partnership or corporation or ownership of a partnership interest or share, viewed as such for Canadian tax purposes, not be recognized or be subject to different characterization in a foreign tax jurisdiction. Indeed, differences in characterization arise under the tax laws of many of Canada's primary trading partners and most common destinations of outbound investment from Canada.

Such differences in taxation systems can provide opportunities for international tax planning or indeed tax arbitrage. However, such differences often arise under normal commercial transactions or as an element of well-trodden local tax planning in the foreign jurisdiction in a manner available to and utilized by investors from other jurisdictions, including competitors to Canadian multinationals.

Direct and indirect foreign tax credits play a vital role in reducing double taxation of income and maintaining the competitiveness of Canadian multinationals (or Canadian based investors). At the same time, there are a multitude of differences in characterization of entities and transactions between Canadian tax and that of particular foreign jurisdictions. The combination of these two factors has the inevitable consequence that a broad proposal which conditions the availability of foreign tax credits under the Act upon consistent characterization of entities and transactions for Canadian and foreign tax purposes will subject certain foreign source income to double taxation. Based on how the Committee reads Resolutions 42 to 44, we believe these measures will make such transactions or investments unviable and will make Canadian based multinationals uncompetitive in such transactions or investments.

The proposals make availability of direct and indirect foreign tax credits conditional upon foreign tax characterization matching that under Canadian tax. This approach has a variety of consequences. Similarly situated Canadian taxpayers, making the same economic investment with the same legal character and subject to the same level of direct or indirect foreign tax are treated differently for Canadian tax purposes – one taxpayer may be allowed a direct or indirect foreign tax credit denied to another Canadian taxpayer based solely upon differences in the characterization of their investment under different foreign tax laws.

Another issue is that changes in the tax law of all foreign jurisdictions are effectively incorporated by reference into the proposed Canadian foreign tax credit regime – legislative or judicial changes affecting characterization of transactions or entities (or measurement or allocation of partnership income) in any foreign jurisdiction will result in a consequential change to the Canadian foreign tax credit system. Thus the proposals significantly complicate tax compliance by taxpayers, the proper administration of the Act by CRA and judicial decision making, each of which becomes dependent upon the application of foreign tax law of one or multiple jurisdictions to the facts.

The consequences of these proposals are immediate, forcing taxpayers to consider unwinding or restructuring established transactions, and restructuring or foregoing proposed transactions, which bear no relationship to the schemes described in the supplementary materials but which would otherwise be subject to both foreign and Canadian taxation under the proposals.

As a result, we believe the scope of these proposals is inappropriate and that the Minister should announce the postponement of these measures while Finance considers a better targeted approach.

We have provided below examples to illustrate these concerns. These examples are not comprehensive. By their terms, the potential of the proposed rules to produce inappropriate double taxation is bounded only by the differences between Canadian income tax and that of each other international jurisdiction in which Canadian based multinationals and investors earn income subject to foreign tax.

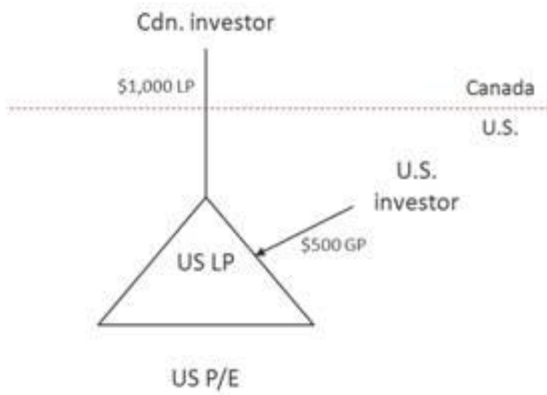
FTC Provision

Proposed subsection 126(4.11) limits the taxpayer's foreign tax credit for foreign taxes paid on income from a partnership if the taxpayer's share of income under the laws of the foreign jurisdiction is less than its share under the Act. In such cases, the tax paid to the foreign country is not included in the taxpayer's business-income tax or non-business-income tax for any year.

However, a taxpayer's share of partnership income may differ under Canadian and foreign tax law for a number of reasons. For example, where a partnership interest is purchased partway through the year, the acquisition could trigger a tax year-end in the foreign jurisdiction but, for Canadian tax purposes, the year-end would depend on the partnership's fiscal period. As a result, the taxpayer's share of income under the foreign tax law may be different and potentially less than it would be under the Canadian tax rules.

Where income of a partnership is subject to foreign taxation, such income will be determined in accordance with foreign tax law (and not in Canadian currency). Inevitably, the amount of partnership income for foreign income tax and Canadian income tax purposes will differ. As a commercial matter, it is not unusual that partners share in partnership income other than pro rata (for example, a partnership share may be fixed, preferential or subject to a base or bonus).

The consequence is that a Canadian partner's share of partnership income for foreign tax purposes will differ from and may be less than the partner's share of such income for Canadian tax purposes. Consider, for example, a Canadian limited and an American general partner which have invested $1000 and $500, respectively, in a partnership which carries on business in the US. Profits of the partnership are allocable first to the limited partner up to 4% of its capital and thereafter are split 50/50. Such profit allocation is specified to apply and respected as applying for US and Canadian tax purposes.[2] The partnership earns $120 of income for US tax purposes which is subject to US tax, while income determined under the Act is $100. Income under the Act is allocable $40 plus $30 = $70 to the Canadian partner and $30 to the US



Partnership	US tax income	120	
	LP allocation	80	
	GP allocation	40	
Cash distribution to LP			$80
US tax paid by LP			$(28)
Net cash			52
Partnership	Cdn. tax income	100	
	LP allocation	70	
	GP allocation	30	
CTOP			(24.5)
FTC			$24.50 or $0?

partner, giving the Canadian partner a 70% share of partnership income for the period. Income for US tax purposes is allocable $40 plus $40 =$80 to the Canadian partner and $40 to the US partner, giving the Canadian partner a 67% share of partnership income for US tax purposes for the period. The effect is that, under the proposals, the Canadian partner may be denied any FTC for US tax paid on partnership income for the period.[3]

Such differences may be permanent or may be the result of timing or currency differences, such that a foreign tax credit may be denied under the proposals in certain taxation years, but allowed in others. There is no carryforward of foreign tax credits denied in respect of a particular taxation year under the proposals.

Further, where the income recorded for Canadian purposes is higher than the income recorded under foreign tax law, a higher Canadian tax liability normally results. It is unclear why

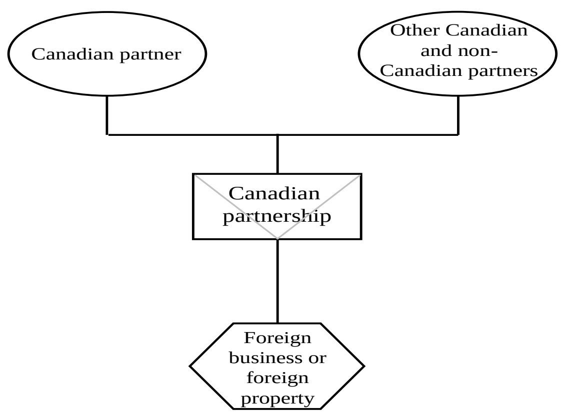
[2] Contractual allocation of partnership income is subject to limitations under the Act (s. 103) and the Internal Revenue Code. This discussion assumes the contractual allocation is respected in both tax regimes. As noted below, often differences in income measurement would reflect timing or foreign exchange differences which one would not expect in themselves to fall afoul of the allocation limitations in the respective tax regimes.

[3] Under current rules, the higher measurement of income for US tax purposes would likely result in excess credits subject to carryforward if any.

Finance would not permit the Canadian taxpayer to claim relief for the foreign tax paid in this case.

The legal character of the entity may also be different under foreign tax law than under the governing commercial law and Canadian legal principles. While an entity may be a partnership for legal and Canadian tax purposes, the entity may be a corporation for foreign tax purposes or the partnership rather than the partners may be subject to tax. Thus, the partner's share of income may be nil for foreign tax purposes (because income is taxed at the entity level and not allocated to its members) but determined under Canadian rules by reference to the partner's share of the underlying profits. In such cases, it seems unreasonable to deny relief for the foreign taxes paid.

In many jurisdictions, partnerships may be subject to tax either on a mandatory or elective basis. Such jurisdictions include Australia, France, the United States and Spain. Consider the following example:

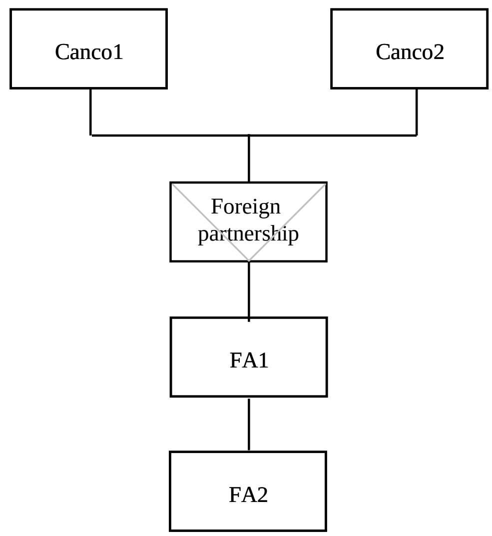


In the real estate industry, it is common practice for Canadian investors to own real estate through a Canadian or U.S. partnership to avoid paying double tax. The Canadian investor typically claims relief for the foreign tax paid, but, to avoid having each individual investor file U.S. federal and state tax returns, the Canadian partnership may file a U.S. check-the-box election to pay U.S. tax at the entity level. In this case, the FTC provision would deny the investor's ability to claim a foreign tax credit for the U.S. tax paid, even though no Canadian or foreign tax on the partnership's profit has been avoided. The result is double taxation of the investors.

FAT Provision

Proposed subsection 91(4.1) limits the taxpayer's right to claim relief for foreign accrual tax paid on amounts included in income as FAPI under subsection 91(1).

The proposed definition of FAT in subsection 95(1) does not include the foreign tax amount that applies to FAPI earned by a partnership which owns shares in a foreign affiliate that earns the income if any Canadian resident partner in the partnership is entitled to a share of income that is less when determined under foreign rules than under Canadian tax rules. This definition may create issues in certain situations. Consider the following example:



A partnership owns shares in a foreign affiliate ("FA1") that earns FAPI and the partnership's income is taxable in the foreign jurisdiction or the partnership is treated as a corporation for foreign tax purposes. Under Canadian rules, the income is allocated to its members. None of the tax paid by the FA1 on that income is available as FAT to the Canadian parent companies ("Canco 1" and "Canco 2"). Similarly, if a foreign affiliate further down the ownership chain ("FA2") generates FAPI, neither Canco 1 nor Canco 2 can claim a FAT deduction for the taxes paid on that income. A similar result arises if the foreign partnership is at a lower tier within the chain of ownership, as long as at least one member is resident in Canada. The presence of any Canadian resident partner in the partnership causes this result, even if the Canadian resident's interest is immaterial.

The proposed FAT definition in subsection 95(1) also does not include the foreign tax amount that applies to FAPI earned in cases where the taxpayer owns fewer shares in the foreign affiliate under foreign tax laws than the taxpayer is considered to own under Canadian tax rules. Again, that tax is not available for purposes of claiming a FAT deduction if the foreign affiliate generates FAPI. It is not clear whether ownership for this purpose refers to actual ownership in shares or the participating percentage that is relevant for FAPI. If actual ownership is considered, then a foreign entity with as little as one share that is treated as debt in the foreign jurisdiction can cause the denial of any FAT claim for taxes paid in that entity or any other entity within the same (vertical) chain of ownership.

Many types of equity instruments, such as, term or retractable preferred shares, are characterized as shares for Canadian tax purposes and debt for foreign tax purposes. The FAT provision would require an analysis of the tax character of all such equity interests not only under the tax laws of the country of residence of the affiliate that issued the interests but also under the tax laws of all other affiliates in the same ownership chain. In many cases, the tax character under such other laws may not be clearly determinable. The FAT provision thus exposes the Canadian taxpayer to significant uncertainty. Similarly, certain entities may be treated as corporations for Canadian tax purposes but as something else for foreign tax purposes. In these cases, the Canadian taxpayer may be considered to own shares for Canadian tax purposes but not for foreign tax purposes, resulting in denial of FAT under the proposals.

While the Committee recognizes that hybrid instruments and entities may be used for tax planning purposes, they are also commonly used for purely commercial purposes. Nothing in Canadian tax law suggests that such arrangements are inconsistent with the object and spirit of the foreign affiliate rules. Further, in most cases, such instruments are used to reduce foreign tax on active business income that is exempt from Canadian tax in any event, rather than to disproportionately increase access to FTCs or FAT. Nevertheless the proposals would deny FAT, notwithstanding that the issuance of a hybrid security within the controlled foreign affiliate ownership chain was unrelated to the earning of the FAPI in respect of which the denied FAT is paid. In the Committee's view, it is not appropriate that the issuance of a hybrid security for commercial or local tax planning purposes in itself preclude relief for FAT. An interest deduction granted by a foreign tax regime in respect of what Canada sees as an equity security may represent common local tax planning available to international competitors, to minimize foreign tax and increase the after foreign tax return to the Canadian or other international investor. The use of hybrid instruments to minimize foreign taxes is not obviously problematic from a Canadian tax policy perspective. The proposals would appear to have the effect of discouraging the use by Canadian based multinationals or investors of hybrid instruments for common foreign tax planning, maximizing foreign tax and minimizing Canadian tax in order to avoid double taxation under the proposals. In any event, a provision that denies foreign tax credit relief in respect of FAPI and taxable surplus often earned in a different entity and country than the one issuing the hybrid instrument is overly broad and improperly targeted.

UFT Provision

Proposed Regulation 5907(1.03) limits the UFT ultimately available for deduction on the repatriation of taxable surplus. Taxable surplus may arise not only by earning FAPI but also by earning active business income in a foreign country other than a designated treaty country and also to the extent of the taxable portion of gains from a sale of shares in a foreign affiliate.

The UFT provisions limits the opportunity of deducting tax paid on such earnings (even if it is Canadian tax) in two scenarios:

- Where the shares owned for foreign tax purposes in the foreign affiliate are less than for Canadian tax purposes; or

- Where a corporation's share of income in a partnership with at least one Canadian resident member that owns shares in a foreign affiliate is less under foreign tax laws than for Canadian tax purposes.

Our comments regarding the FAT provision also apply to the UFT provision.

Further, the Budget Proposals suggest that the provisions are intended to apply to loans but their scope is not limited to financing income. Thus, similar considerations arise for any taxable surplus or FAPI within a foreign affiliate group regardless of the nature of the income.

FAT applies to interests in controlled foreign affiliates, where the Canadian investor would typically have control over the structure of the investment. An FTC can arise from a minority and/or limited partnership interest and UFT arises in respect of interests in a foreign affiliate. In neither case would the Canadian investor necessarily have control over the underlying investment and its foreign tax characterization. Often a minority Canadian investor would not have ready access to the information necessary to determine foreign tax characterization of transactions. Thus, in respect of the FTC and UFT proposals, there will be more circumstances in which restructuring an investment to accommodate the proposals is not a commercial option and the prospective Canadian investor's practical choice will be to forego investments or become subject to double taxation.

Effective Date

As noted above, the role of direct and indirect foreign tax credits to protect against double taxation of foreign source income is fundamental to the regime under the Act for taxation of such income. Thus, even on a prospective basis, conditioning availability of the direct or indirect foreign tax credits upon consistent characterization of transactions in foreign tax regimes risks, for the reasons discussed above, reducing the competitiveness of Canadian based multinationals and investors which are required to restructure or forego prospective investments and transactions to avoid double taxation.

The proposals are not prospective, but proposed to apply to taxation years ending after March 4, 2010, with no grandfathering of existing transactions. The proposals apply to partnership interests and FAPI of controlled foreign affiliates, both regimes which include income of entities for fiscal periods ending in a taxation year, with the result that in situations where the taxation year of the taxpayer is not matched to that of the partnership or controlled foreign affiliate, as the case may be, the proposals apply to periods commencing one to two years prior to announcement.

The retroactive introduction of punitive double taxation to existing business transactions structured to take into account appropriate tax and commercial planning under foreign and (pre-Budget) Canadian law is not appropriate tax policy.

Recommendation:

We believe that it is not the intention of the Department of Finance to deny the availability of foreign tax relief to a wide variety of multinational structures as a side effect of the Department's goal to eliminate schemes undertaken by a relatively small number of taxpayers designed to create artificial foreign tax credits.

As noted above, these proposals, as drafted, have far reaching consequences that have the effect of double taxing income arising from legitimate business transactions and arrangements. We are sure that there are many other examples that have not yet been identified. Rather than moving forward and introducing exceptions for non-controversial transactions, we believe that it is necessary to take a step back for further thought, as the Department did for the Non-Resident Trust and Foreign Investment Entity proposals.

Consequently, given the broad application of these proposals, their impact on existing and proposed investments, transactions, financing and ownership structures, public companies and public partnerships and the potential for these public entities to have to disclose the impact of these proposals to their shareholders and unit holders, the Committee's view is that the Minister should immediately announce the postponement of these proposals until further review and consultation is undertaken.

Finally, as the Budget Proposals suggest, even if these measures are suspended, particular existing schemes described in the Budget Proposals could still be challenged currently under the general anti-avoidance rule (GAAR). One reason for the introduction of the GAAR was to eliminate the need to create complicated tax rules to address abusive tax schemes as they arise.

4. Interest on Overpaid Taxes

The Budget Proposals include a proposal to reduce the interest rate paid on refunds to corporations from the T-bill rate + 2% to the T-bill rate, while leaving the interest rate charged on tax owing at the T-bill rate + 4%. The stated reason for this reduction is that the Auditor General indicated in her most recent report that the government is effectively increasing its cost of borrowing by paying a higher rate of interest on refunds of tax than the rate at which it can borrow directly. Similar arguments for a lower rate to be charged on taxes owing could be made by taxpayers comparing the rate of non-deductible interest charged by the CRA on unpaid tax to the taxpayer's cost of funds. Anecdotally we understand that the impetus for the proposal may be to prevent taxpayers from intentionally overpaying their taxes in order to receive a higher rate of interest from the CRA than they would receive from other deposits.

It is reasonable to assume that the purpose for paying or charging interest under the Act is to compensate for the time value of money. The rate of interest should neither reward nor penalize either taxpayers or the CRA.

Taxpayers have legitimate concerns, in general, regarding the gap between the taxable lower rate of interest paid by the CRA on refunds, compared to the higher non-deductible rate of interest charged by the CRA on taxes owing. Leaving those concerns aside, a troubling aspect of the proposed change is that large corporations are generally forced to pay one-half of any tax that has been reassessed, even though they are disputing the reassessment. Reassessments are often issued without the taxpayer receiving a full hearing on either the facts or the law, and are often reversed after the objection process has been completed. Forcing large corporations to pay one-half of the tax in dispute, only to receive low rate taxable interest if they are successful, is penal in nature.

Recommendation:

We recommend that any refund issued as a consequence of an amount paid pursuant to a notice of reassessment be excluded from the proposed reduced interest rate rule.