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

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September 13, 2012

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

Re: August 14, 2012 Draft Legislative Proposals to Amend the *Income Tax Act* (Canada)

Dear Mr. Ernewein:

Please find enclosed our submission on the provisions in the August 14, 2012 draft legislative proposals (the "**Legislative Proposals**") to amend certain provisions of the *Income Tax Act* (Canada) (the "**Act**") pertaining principally to international taxation.

The Legislative Proposals amend many rules. In this submission, we address those proposals related to foreign affiliate dumping, thin capitalization, employee profit sharing plans ("**EPSPs**") and partnerships.

Our submission is focused principally on the foreign affiliate dumping rules. We are concerned that the measures apply a single set of rules to curtail both debt dumping and surplus stripping, two fundamentally different transactions. A separate set of rules to implement each policy objective would reduce the likelihood of inappropriate results being obtained. The rules give rise to multiple taxation in common commercial transactions for what is effectively the same investment; obviously, this cannot be justified on any basis.

We reiterate our concern that they apply to public companies and will adversely impact capital markets. These concerns have been heightened by the new indirect acquisition rule, which the 2012 federal budget did not even remotely foreshadow. This rule applies to a broad range of transactions, including some common domestic transactions. We encourage further study as to whether the rule is necessary to preserve the integrity of the foreign affiliate dumping regime, and as to the broader impact of the rule on the Canadian economy as a whole.

From a technical perspective, anomalies and inconsistencies with the measures are illustrated in Appendices A and B attached to our submission. The rules are extremely mechanical and, quite simply, are far too broad. Further, the new indirect acquisition rule has unintended effects and thus ought to be reconsidered.

In this submission, we raise technical issues that arise in connection with the Legislative Proposals and reiterate certain policy concerns identified previously in our prior submission dated June 8, 2012 (the "**Submission**") that persist under the Legislative Proposals.

Some of our comments are provided in abbreviated form because of the short time period for comment. We may not have identified all of the issues arising under the Legislative Proposals. We will submit an addendum at a later date.

It is essential that we meet to discuss our submission in greater detail. We would like to schedule such a meeting as soon as possible.

Subcommittee Members

Several members of the Joint Committee participated in discussions concerning our submission and contributed to its preparation, in particular:

Bill Brebber
(Ernst & Young LLP)

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(KPMG LLP)

We would also like to acknowledge contributions of non-committee contributors which included Steve Ruby (Davies Ward Phillips & Vineberg LLP) and Jeff Oldewening (Moskowitz & Meredith LLP).

We trust that you will find our comments helpful.

Yours very truly,

P. Woolford

Penny Woolford
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Darcy D. Moch

Darcy Moch
Chair, Taxation Section
Canadian Bar Association

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SUBMISSION

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (the "**Joint Committee**") is pleased to provide this submission on the provisions of the Legislative Proposals.[1]

Our submission discusses certain technical issues under the Legislative Proposals related to foreign affiliate dumping, thin capitalization, EPSPs and partnerships.

I. Foreign Affiliate Dumping

In respect of the revised foreign affiliate dumping proposals (the "**Revised Proposals**"), we note that certain aspects of the proposals have changed from their initial formulation (the "**Initial Proposals**") as presented in the 2012 federal budget. We are pleased that the Department of Finance (Canada) ("**Finance**") addressed some of our concerns about the Initial Proposals identified in the Submission. However, we believe that certain policy, structural and technical issues persist, and that certain new issues have emerged, in that the Revised Proposals can lead to results that are inconsistent with our understanding of Finance's stated policy objectives and that in many cases can be arbitrary, duplicative or otherwise punitive.

In general, the Revised Proposals apply where a non-resident corporation (the "**FP**") controls, or through a series of transactions or events, acquires control of, a corporation resident in Canada (the "**CRIC**"), and the CRIC makes a direct (or in some cases indirect) "investment"[2] in a non-resident corporation called a "subject corporation" (the "**SC**") that is, or as part of the series becomes, a foreign affiliate of the CRIC, subject to certain exceptions. The Revised Proposals reflect the following apparent policy objectives:

- to prevent erosion of the Canadian tax base attributable to transactions involving an acquisition of an SC by a CRIC from an FP controlling the CRIC that result in a net deduction from Canadian-source income or create paid-up capital in shares of the CRIC to increase thin-capitalization room or to facilitate a return of capital from Canada free of Canadian withholding tax, and

- to deter "surplus stripping" of the earnings of the CRIC by the FP free of Canadian withholding tax through an investment in the SC by the CRIC

unless the following conditions are met:

- the business activities carried on by the SC are more closely connected to the business activities carried on in Canada by the CRIC than to the business activities carried on by any non-arm's length, non-resident corporation (other than the SC, determined on a look-through basis) with which the CRIC does not deal at arm's length;

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1 Unless otherwise indicated, all statutory references are to the provisions of the Act as amended by the Legislative Proposals.

2 Defined in subsection 212.3(8).

- the principal decision-making authority in respect of the investment in the SC must be made by officers of the CRIC of which a majority must be resident and work primarily in Canada; and
- the performance evaluation and compensation of such officers of the CRIC must be based on the results of the SC to a greater extent than the performance evaluation and compensation of any officer of any other relevant non-resident corporation.

The Revised Proposals would also introduce new exceptions for certain types of "reorganizations", and rules to exclude a "pertinent loan or indebtedness" (a "**PLOI**"), together with a companion exclusion from the rules in subsection 15(2).

We reiterate our concern that the foreign affiliate dumping rules affect both types of transactions, whereas a separate set of targeted rules to implement each policy objective is preferable.

Nevertheless, we limit our submission to identifying certain technical issues that arise under the revised foreign affiliate dumping rules. To supplement our submissions in the body of this letter, we attach as Appendices A and B a number of specific examples that illustrate some of the anomalies under the foreign affiliate dumping rules.

A. Section 15

Subsection 15(2) does not apply to a PLOI. Subsection 15(2.11) defines a PLOI for purposes of subsection 15(2) and proposed section 17.1, generally as a loan received, or indebtedness incurred, by a non-resident corporation (the "**Subject Corporation**") to which subsection 15(2) would otherwise apply if (a) the amount becomes owing after March 28, 2012, (b) at the time the amount becomes owing the CRIC was controlled by a non-resident corporation that is the Subject Corporation or does not deal at arm's length with the Subject Corporation, and (c) the CRIC and the non-resident corporation that controls the CRIC jointly elect in respect of all loans and indebtedness that become owing after March 28, 2012 by the Subject Corporation to the CRIC.

1. Technical Concerns

We have several concerns about the drafting of paragraph 15(2.11)(c).

a) While the policy rationale for this requirement is not evident, paragraph 15(2.11)(c) requires that the election be made in respect of "all loans and indebtedness that became owing after March 28, 2012 by the subject corporation to the CRIC" even if not all those loans or indebtedness would otherwise be subject to subsection 15(2). Although the Explanatory Notes suggest that the election is only to be made in respect of loans or indebtedness that would otherwise be subject to subsection 15(2), that condition is not found in paragraph 15(2.11)(c). To illustrate, if a loan is made by a CRIC to the Subject Corporation on January 1, 2013, and it is not repaid within the period required by subsection 15(2), in order for that loan to be a PLOI, paragraph 15(2.11)(c) requires the CRIC and non-resident to elect there under "in respect of all loans and indebtedness that become owing after March 28, 2012 by the subject corporation to the CRIC". The only reference to subsection 15(2) is in the preamble of subsection 15(2.11) and, in this example, that language modifies only the January 1, 2013 loan, not other short-term loans of the CRIC such as trade receivables. Thus, the ability to make the election for the January 1, 2013 loan will be lost if the election is not made by the filing due date for the year in which only a loan that is not subject to subsection 15(2) has been made.

b) Because paragraph 15(2.11)(c) requires the election to be made in respect of all loans and indebtedness that become owing after March 28, 2012, if the loan made on January 1, 2013 in the above example is not treated as PLOI because no timely election is made but another loan is made in 2016, that second loan cannot be treated as a PLOI because the condition in paragraph 15(2.11)(c) would not be satisfied: there would have been a loan that arose after March 28, 2012 (the January 1, 2013 loan) that would not have been treated as PLOI.

c) It is not clear how one can elect in respect of indebtedness where, at the time the indebtedness is incurred, it is not clear whether absent the election the indebtedness would be subject to subsection 15(2). If an election was made in respect of the loan made on January 1, 2013, the taxpayer may not know that a subsequent loan will remain outstanding sufficiently long for subsection 15(2) to otherwise apply.

d) The simultaneous control rule in subsection 212.3(11) does not apply for purposes of subsection 15(2.11). This introduces uncertainty as to who may file the PLOI election. Presumably, any non-resident corporation (including the FP) that simultaneously controls the CRIC is eligible to participate in the joint election.

e) Subsection 15(2.11) would apply only to “an amount owing to a corporation resident in Canada”. Thus, it is not clear that this election can be made where there is an amount owing to a partnership of which a corporation resident in Canada is a member.

2. Policy Concern

Proposed subsection 15(2.11) also raises the following policy concerns.

There does not appear to be any policy reason for requiring "all" loans and indebtedness that become owing after March 28, 2012 by the Subject Corporation to the CRIC to be subject to the regime in section 17.1. We also question why the election must be made jointly by the CRIC and a non-resident corporation. In our view, the CRIC should be permitted the choice to elect either that this regime be applicable to all relevant loans or indebtedness of the Subject Corporation or separately in respect of each loan or indebtedness that would otherwise be subject to subsection 15(2). At a minimum, there should be an exception for trade receivables arising in the ordinary course of business.

Moreover, it is unclear whether existing loans can be transitioned to the new regime. In particular, subsection 15(2.6) provides that subsection 15(2) does not apply where an existing loan is repaid within one year, but this exception does not apply where the repayment is part of a series of loans or other transactions and repayments. The concept of “series” in subsection 15(2.6) introduces uncertainty as to whether an existing loan can be repaid with the proceeds of a PLOI. If such a repayment constitutes part of a series, then the existing loan remains subject to subsection 15(2) and cannot be migrated to the new regime for a PLOI.

Recommendation

We recommend the following:

- amend subsection 15(2.6) to exclude from the concept of a series of loans or other transactions and repayments any repayment sourced from the proceeds of a PLOI. In the alternative, the PLOI election should be available in respect of existing loans and indebtedness with effect from March 29, 2012;
- the CRIC should be entitled to elect on its own. In the alternative, the simultaneous control rule in subsection 212.3(11) should apply for purposes of the definition of PLOI in subsection 15(2.11) as well as that in subsection 212.3(9);
- the election should be permitted in respect of each loan or indebtedness that would otherwise be subject to subsection 15(2). In the alternative, paragraph 15(2.11)(c) could read as follows:

> (c) the CRIC and a non-resident corporation that controls the CRIC jointly elect in writing under this paragraph that the particular loan or indebtedness, and <u>all other loans received by the subject corporation from the CRIC (or indebtedness to the CRIC incurred by the subject corporation) to which subsection 15(2) would, in the absence of this subsection, apply and that become owing on or after the day the particular loan or indebtedness became owing, be a pertinent loan or indebtedness</u>.

Some of these concerns (particularly those relating to paragraph 15(2.11)(c)) also apply to the definition of PLOI found in subsection 212.3(9).

B. Section 17.1

Section 17.1 applies if a non-resident corporation owes an amount to a CRIC and the amount owing is a PLOI.[3] In that case, section 17 does not apply in respect of the amount owing and the CRIC is required to include in income an imputed amount in respect of the PLOI.

The amount included in income under section 17.1 should be reduced to the extent amounts are otherwise required to be included in income as foreign accrual property income ("**FAPI**") that can reasonably be attributed to interest on the amount owing. This may arise where a controlled foreign affiliate of a CRIC uses the proceeds of a PLOI to earn FAPI. Wording similar to that in subparagraph 17(1)(b)(iii) should be included to eliminate the prospect of a duplicative income inclusion.

Section 17.1 applies to impute income on a PLOI, which is defined by reference to when the "amount becomes owing". Thus, notwithstanding that the CRIC is no longer controlled by a non-resident corporation or that the non-resident corporation is no longer a foreign affiliate, section 17.1 continues to apply if there remains an amount owing. The rule should cease to apply once the relevant relationships no longer exist. The appropriate time of cessation depends

[3] In this context, "PLOI" takes its meaning from the definitions in subsections 15(2.11) or 212.3(9).

on whether the definition of PLOI in subsection 15(2.11) or 212.3(9) applies.

Similarly, variable A of paragraph 17.1(b) includes interest payable by a person resident in Canada with whom the CRIC did not, *at the time the amount owing arose*, deal at arm's length, if the interest is payable on a debt obligation that directly or indirectly funded the PLOI. If Sub1 and Sub2 are related and Sub2 borrows money from a bank which is used indirectly to fund a PLOI by Sub1, interest payable by Sub2 on its borrowing should only be relevant for so long as the parties remain in a non-arm's length relationship. For example, if Sub2 is sold to an arm's length person but its bank loan is not repaid, Sub1 should no longer be required to take into account interest payable by Sub2 on that bank loan.

Recommendation

We recommend the following:

- section 17.1 should not impute income on a PLOI where the CRIC includes in income FAPI that relates to the PLOI; and
- section 17.1 should cease to apply once the relevant relationships cease.

C. Section 212.3

1. Subsection 212.3(1)

Subsection 212.3(2) applies to an "investment"[4] in an SC made at any time (the "**investment time**"[5]) by a CRIC if:

- the SC is immediately after the investment time, or becomes as part of a transaction or event or series of transactions or events that includes the making of the investment, a foreign affiliate of the CRIC,
- the CRIC is at the investment time, or becomes as part of a transaction or event or series of transactions or events that includes the making of the investment, controlled by the FP; and
- neither subsection 212.3(12) nor (13) applies, each of which excepts certain transactions that meet a "business purpose exception" (the "**BPE**") and certain reorganization and distribution transactions, respectively.

Paragraphs 212.3(1)(a) and (b) import into the ambit of section 212.3 a concept of "series of transactions or events." At common law, a "series of transactions" involves transactions that are "pre-ordained in order to produce a given result" with "no practical likelihood that the pre-planned events would not take place in the order ordained." [6] Subsection 248(10) extends the

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4 Defined in subsection 212.3(8).

5 Defined in subsection 212.3(1).

6 *Canada Trustco Mortgage Co. v. The Queen*, [2005] 5 C.T.C. 215 para. 25 (S.C.C.). In this sense, "pre-ordination" means that when the first transaction of the series is implemented, all of the essential features of the

common law meaning of "series of transactions or events" to include a transaction in a series, whether it transpired before or after the series, if the parties to the transaction "knew of the [...] series, such that it could be said that they took it into account when deciding to complete the transaction."[7] Thus, section 212.3 can apply where a CRIC becomes controlled by a FP as part of a series that includes an investment in an SC by the CRIC. An example illustrates the over breadth of this extension of the rule from the Initial Proposals.

In an active market for mergers and acquisitions, a foreign multinational may wish to acquire control of a Canadian-resident corporation that transacts with its foreign affiliates on an ongoing basis. In these circumstances, it may be difficult to determine the scope of the series and the BPE may not be available. In particular, the investment in the SC by the CRIC may be caught even though the CRIC would have made the investment without regard to the FP's pending acquisition of control of the CRIC.

Recommendation

We recommend that subsection 212.3(1) should not apply to investments in an SC by a CRIC made at a time before the CRIC becomes controlled by an FP, where such investments are not motivated by a pending acquisition of the CRIC by the FP.

2. Subsection 212.3(2)

Subsection 212.3(2) sets out the consequences of foreign affiliate dumping. In particular, for purposes of Part XIII, and subject to elective relief,[8] the CRIC is deemed to have paid to the FP, and the FP is deemed to have received from the CRIC, at the investment time, a dividend equal to the total of the FMV at the investment time of any property (except shares of the CRIC) transferred, any obligation assumed or incurred or any benefit otherwise conferred, by the CRIC that can reasonably be considered to relate to the investment. Further, at the investment time and thereafter, the paid-up capital ("**PUC**") of the shares of the CRIC is reduced by the amount of any increase in PUC that can reasonably be considered to relate to the investment in the SC where the CRIC provides shares in consideration.

In many situations, the FP does not own the shares of the CRIC directly. Consider the following example. The FP owns shares of a Canadian-resident holding company ("**CanHoldco**").

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subsequent transactions are determined by persons who have the firm intention and ability to implement them: see *OSFC Holdings Ltd. v. The Queen*, 2001 D.T.C. 5471 at para. 24 (F.C.A.). The inquiry focuses on whether the parties intended a number of transactions to produce a "composite result" that engages a provision of the Act. If the parties so intend and have the ability to execute the transactions, each such transaction will be considered to be part of the series: see *Canutilities Holdings Ltd. v. The Queen*, 2004 D.T.C. 6475 at para. 65 (F.C.A.).

[7] *Canada Trustco*, *ibid.* at para. 26. The phrase "in contemplation" does not mean actual knowledge but rather means "because of" or "in relation to" the series: *ibid*. Although the "because of" or "in relation to" test does not require a "strong nexus," it does require more than a "mere possibility" or a connection with "an extreme degree of remoteness"; the length of time between the series and the related transaction may be a relevant consideration in some cases, as would intervening events taking place between the series and the completion of the related transaction: see *Copthorne Holdings Ltd. v. The Queen*, [2011] 3 S.C.R. 721.

[9] Paragraph 88(1)(d).

CanHoldco owns the shares of the CRIC. The FP lends funds to the CRIC, and the CRIC uses the proceeds to invest in the SC. Under section 212.3, the CRIC is deemed to pay a dividend directly to the FP. Under most treaties, the Canadian withholding rate on the deemed dividend is the higher treaty-reduced rate.

The phrase "that can reasonably be considered to relate" is too broad. For example, if a CRIC borrows money from a Canadian bank and uses the funds to acquire shares of an SC, with little difficulty the language supports an interpretation that the obligation incurred to the bank "can reasonably be considered to relate" to the investment in the SC shares. Indeed one would expect that the bank loan documentation will state that the purpose of the loan is to acquire the SC shares and require the SC shares to be security for the loan. At the same time, the borrowed money paid to the vendor of the SC shares is property transferred to acquire the SC shares and also relates to the investment. While the Explanatory Notes provide an example which suggests the obligation to the bank would not give rise to a dividend because it is "one step removed", we believe that the legislation itself needs to be much clearer. We recognize that the Explanatory Notes say that the "reasonably relate" language is "mainly to deal with situations in which the 'indirect' rule in paragraph 212.3(8)(f) is applicable". However, the modifier "mainly" in this passage is troubling. Further, the text of the provision is open to a broad interpretation. The intended scope of the rule should be made clear in the text of the legislation. This may require a separate rule for dealing with investments described in paragraph 212.3(8)(f).

Recommendation

We recommend that a dividend deemed to be paid by a CRIC should be considered to have been paid to the FP up the chain of entities in the group so that the rate of Canadian withholding tax is determined by the rate that would apply to a dividend paid by the top-tier Canadian holding company to the lowest-tier non-resident entity.

3. Subsections 212.3(4) and (5)

Subsections 212.3(4) and (5) allow the CRIC and the FP to elect to treat what would otherwise be a deemed dividend under paragraph 212.3(2)(a) instead as a return of capital out of pre-existing PUC of the CRIC. In particular, the election is available if:

- a deemed dividend under paragraph 212.3(2)(a) arose on an investment in an SC made by a CRIC;
- the CRIC has only one class of shares, or where it has multiple classes, the investment in the SC by the CRIC can be traced to a contribution to a particular class of shares of the CRIC;
- all shares of the CRIC that were not owned by the FP were owned by persons dealing at arm's length with the CRIC; and
- a joint election is made by the CRIC and the FP.

Where the election is made, the deemed dividend is eliminated to the extent of the pre-existing PUC of the CRIC, and such pre-existing PUC of the CRIC is reduced accordingly.

It is our view that the default treatment should be a reduction to the pre-existing PUC of the shares of the CRIC rather than a deemed dividend. No election should be required to have a PUC grind. Any excess grind over PUC would then give rise to a dividend. The CRIC and the FP should be entitled to elect deemed dividend treatment rather than a PUC grind. This measure should also apply to CRICs held by Canadian-resident corporations, and where the FP's ownership of the CRIC is divided amongst non-arm's length, non-resident holding entities.

In this way, the CRIC would not be required to withhold (where possible) and remit Part XIII tax where the CRIC has sufficient pre-existing PUC except by conscious choice. As drafted, taxpayers will inadvertently trigger a tax withholding obligation when sufficient PUC is available.

Under the Legislative Proposals, the entire dividend is deemed to be paid by the CRIC to the FP, irrespective of the FP's actual percentage ownership. This produces an obviously unfair result. In contrast, any PUC grind is borne by all shareholders. Since all shareholders benefit from the investment in the SC, it seems inappropriate that the deemed dividend received by the FP should exceed an amount corresponding to its actual percentage ownership of the CRIC.

The PUC for which a suppression election can be filed is inappropriately limited. There is no good reason for the requirement to trace the creation of the PUC to the property transferred to the CRIC where there are multiple classes of shares of the CRIC. Many of these issues are illustrated in the attached examples in Appendix A.

Recommendation

We recommend that PUC suppression should be the default position. It should not require tracing even if more than one class of shares is outstanding. It should apply to lower tier CRICs and should not be denied because of split ownership of the CRIC by the FP through intermediary entities. PUC suppression should also be available where cash was contributed to the CRIC on a capital contribution.

If our recommendation that a dividend deemed paid by a CRIC should be considered to have been paid to the FP up the chain of ownership through the relevant intermediate entities so that Canadian withholding tax applies to the dividend deemed paid by the top-tier Canadian holding company to the lowest-tier non-resident holding company is accepted, then perhaps these two recommendations could be implemented by allowing the PUC suppression election to be made by any CRIC in the chain to the extent that it would otherwise be deemed to have paid a dividend to a non-resident person.

4. Subsection 212.3(6)

Subsection 212.3(6) adjusts PUC of the shares of the CRIC reduced under paragraphs

212.3(2)(b) or (5)(b) in order to avoid inappropriate results where, because of a share redemption, acquisition, or cancellation or a reduction of PUC, subsection 84(3), (4) or (4.1) deems a dividend to arise in respect of the PUC reduction.

The PUC adjustment does not take into account subsection 84(2), which applies on a distribution by a CRIC on the winding-up, discontinuance or reorganization of its business. There does not appear to be a specific reason why subsection 84(2) was not included in the list.

Recommendation

We recommend amending subsection 212.3(6) to add a reference to subsection 84(2).

5. Subsection 212.3(7)

Subsection 212.3(7) reinstates the PUC of the shares of the CRIC reduced under paragraph 212.3(5)(a) immediately before a return of capital in certain cases.

More specifically, where paragraph 212.3(5)(b) applies to reduce the PUC of the shares of the CRIC on an acquisition of shares of the SC, the PUC of the CRIC shares is increased immediately before a return of capital on those shares by the least of:

- the amount of the return of capital on the shares of the CRIC;
- the amount by which the PUC grind under paragraph 212.3(5)(b) exceeds the total PUC reinstatements under subsection 212.3(7) for the shares of the CRIC; and
- an amount that:
  - if the return of capital constitutes a distribution of the SC shares acquired by the CRIC, or property substituted for the acquired shares, is equal to the FMV of the acquired shares or the portion of the FMV of the substituted property that may reasonably be considered to relate to the acquired shares;
  - the CRIC demonstrates that it has received after the investment time and within 30 days before the return of capital as proceeds of disposition for the acquired shares or as the portion of proceeds from the disposition of property substituted for the acquired shares that may reasonably be considered to relate to the acquired shares; or
  - if neither of the prior two situations applies, is equal to nil.

This rule is deficient for the following reasons.

a) The preamble of subsection 212.3(7) applies in respect of an investment in an SC by a CRIC that is an acquisition of shares of the capital stock of the SC. This language does not take into account any other type of investment in an SC, such as a contribution of capital, indebtedness, an option, or an “indirect acquisition” described in paragraph 212.3(8)(f), which includes an acquisition of shares of a CRIC in certain circumstances. There is no justification for limiting the scope of subsection 212.3(7) so severely.

To illustrate, consider the following example. A CRIC may invest in an SC that is a foreign affiliate by a contribution of capital without subscribing for shares of the SC. This form of investment is required in some jurisdictions, such as under the "quota share" regime in Hungary, because capital of the SC is not divisible into shares so that under foreign corporate law no new shares can be issued. There is no policy reason for denying PUC reinstatement in this example.

b) The PUC reinstatement may not apply in respect of an "indirect acquisition" described in paragraph 212.3(8)(f) because the investment is not a direct acquisition of shares of the SC. Even if it were, it is unclear how clause 212.3(7)(c)(ii)(B) applies. Subparagraph 212.3(7)(c)(ii) would reinstate the PUC of the shares of the CRIC in an amount that the CRIC demonstrates that it has received after the investment time and no more than 30 days before the return of capital as proceeds from the disposition of the acquired shares or as the portion of the proceeds from the disposition of property substituted for the acquired shares that may reasonably be considered to relate to the acquired shares. Perhaps, in respect of an "indirect acquisition," the top-tier CRIC can apportion the proceeds from the sale of shares of the bottom-tier CRIC according to the FMV of its foreign affiliates, and subsection 212.3(7) then reinstates PUC of the shares of the top-tier CRIC to the extent of that apportionment immediately before the return of capital to the FP by the top-tier CRIC. But the text of the provision needs to be much clearer, as other interpretations are possible. We understand the intention to be that the "indirect investment" is to be treated as if the top-tier CRIC acquired the shares of the SCs owned by the bottom-tier CRIC directly, and each foreign affiliate is to be treated and tested separately as a SC for purposes of these rules. If Finance intends this result, a specific deeming rule similar to those in subsection 212.3(18) that applies in the context of partnerships is necessary.

We understand that Finance is aware of this latter problem. In particular, we understand that (contrary to the text of the Legislative Proposals) the PUC reinstatement is intended to be available for an "indirect acquisition" described in paragraph 212.3(8)(f), and that Finance is drafting additional language to reflect this intention.

c) The preamble of subsection 212.3(7) provides for a reinstatement of PUC only if a PUC grind arose pursuant to elective relief under paragraph 212.3(5)(b). The omission of a PUC reinstatement for an automatic PUC grind under paragraph 212.3(2)(b) is not justified. From a policy perspective, there is no distinction between the following two series of transactions:

1. An FP contributes funds to a CRIC, and the CRIC uses such funds to acquire an investment in the SC from the FP (which results in a deemed dividend which can be treated as a PUC reduction and later reinstated); and
2. A CRIC acquires an investment in a SC from its FP directly in consideration for shares of the CRIC (which results in a PUC reduction to which no election can be made and no reinstatement).

Each of these transactions should give rise to the same tax consequences.

d) The PUC reinstatement under subsection 212.3(7) is available immediately before the return of capital to the FP by the CRIC – but only in respect of the very same class of shares that was subject to the PUC grind under paragraph 212.3(5)(b). If the initial shares are exchanged (for example, on an amalgamation), the suspended PUC does not trace to be reinstated as PUC of the exchanged shares. This imposes a trap for the unwary, and may inhibit some reorganizations or result in the unintentional loss of PUC for making a future distribution.

e) In some cases, foreign tax considerations make it inadvisable to extract an investment in an SC made by a CRIC by a return of capital to a FP. Consider a Mexican-resident FP that acquires control of a CRIC that owns a Mexican-resident SC as a foreign affiliate through a Canadian acquisition corporation. On the amalgamation of the two Canadian corporations to form "Amalco," Amalco "bumps" the cost of the SC.[9] However, to eliminate the "sandwich" structure tax-efficiently from a Mexican tax perspective, it is desirable for Amalco to emigrate from Canada rather than to distribute the shares of the SC to the FP as a return of capital. In respect of the emigration, the PUC reinstatement under subsection 212.3(7) is not available. Therefore, on the emigration, Amalco may be deemed by section 219.1 to pay a divided to FP.

Thus, the taxpayer is forced to choose between adverse Mexican or Canadian tax consequences in eliminating the sandwich structure.

Similar concerns arise with respect to distributions made by way of a redemption of shares of a CRIC rather than a return of capital.

f) There appears to be overlap between subparagraphs 212.3(7)(c)(i) and (ii). In particular, where the shares of an SC are sold by a CRIC, the proceeds may constitute both "proceeds from the disposition of the acquired shares" and, at the same time, "property substituted for the acquired shares." This dichotomy leads to ambiguity as to which provision applies, and could lead to inconsistent results.

g) Because PUC was previously denied, the distribution in question would be a distribution in the form of a reduction of legal stated capital, not PUC. The language of the provision should be amended to clarify this point.

h) Double taxation can arise. Consider the following example. An FP controls a CRIC, the shares of the CRIC have PUC of nil, and the CRIC makes an investment in an SC. A deemed dividend under paragraph 212.3(2)(a) will arise equal to the fair market value of the investment. There has been no addition to the PUC of the shares of the CRIC, and no ability to elect to reduce the amount of the deemed dividend because the CRIC has no pre-existing PUC in its shares. Double taxation will result on a subsequent distribution from the CRIC in respect of the amount invested in the SC. In this example, it would be appropriate to bump the PUC of the shares of the CRIC by the amount of the deemed dividend (except for thin capitalization purposes) in order to avoid double taxation on the subsequent distribution.

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[9] Paragraph 88(1)(d).

Recommendation

We recommend the following:

- amend subsection 212.3(7) to apply to all types of investments in an SC by a CRIC (including indirect investments under subsection 212.3(8)(f));
- amend subsection 212.3(7) to apply on a reduction of the PUC of the shares of a CRIC under paragraph 212.3(2)(b);
- the PUC reinstatement that is suspended should trace to other shares where the shares of the CRIC that are the subject of the suspended PUC reinstatement are exchanged;
- the PUC reinstatement should be available on an emigration of the CRIC, and on a redemption of shares of the CRIC where the appropriate property is thereby distributed;
- clarify which of subparagraphs 212.3(7)(c)(i) and (ii) apply where a CRIC sells shares of an SC; and
- increase the PUC of the shares of the CRIC by the amount of any deemed dividend under paragraph 212.3(2)(a) where the investment was not funded (directly or indirectly) with borrowings that give rise to deductions in Canada in order to avoid the potential for double taxation.

6. Subsection 212.3(8)

a) Paragraph 212.3(8)(a)

Generally, subsection 212.3(8) defines an "investment" in an SC by a CRIC. An "investment" in an SC made by a CRIC includes an acquisition of shares of the SC by the CRIC.[10] However, certain acquisitions of shares of an SC by the CRIC generate income subject to tax in Canada.

For example, the SC may earn FAPI imputed to the CRIC on a current basis. Alternatively, the CRIC may be required to include in income dividends received from the SC[11] out of hybrid surplus or taxable surplus, a portion of which is not fully deductible in computing taxable income.[12]

Recommendation

Investments that produce currently taxable income ought to be excluded from the ambit of the foreign affiliate dumping rules on the basis that they do not erode the Canadian tax base, in a manner consistent with the PLOI rules.

10 Paragraph 212.3(8)(a).
11 Paragraph 12(1)(k) and section 90.
12 Paragraphs 113(1)(a.1) and (b).

b) Paragraph 212.3(8)(e)

Paragraph 212.3(8)(e) provides that an "investment" in a SC made by a CRIC includes an extension of the maturity date of a debt obligation owing by the SC to the CRIC, or the redemption, acquisition or cancellation date of shares of the SC owned by the CRIC.

As a starting point, an extension is not a new investment either in economic substance or legal form. Therefore, whether an extension ought to be an "investment" in an SC is questionable.

Further, the concept of an "extension" is novel and somewhat unclear. Presumably, demand loans which have no fixed maturity are not subject to this rule. This point should be clarified.

In any event, as drafted, an extension constitutes an "investment" whether or not the initial acquisition of the debt obligation or the shares of the SC gave rise to the application of subsection 212.3(2). Therefore, the PUC-reduction or deemed dividend arising under subsection 212.3(2) can effectively arise multiple times in respect of the same investment, even though the extension at issue may be immaterial or may be required for valid commercial reasons (*i.e.*, the lenders to the SC will not permit the loan to be repaid).

Recommendation

Paragraph 212.3(8)(e) should exempt an extension of a debt obligation or a redemption, acquisition or cancellation date of shares of an SC where the acquisition of such debt obligation or shares of the SC has already prompted the application of subsection 212.3(2) or where the debt obligation is a PLOI.

c) Paragraph 212.3(8)(f) and Subsection 212.3(10)

(1) Paragraph 212.3(8)(f)

Paragraph 212.3(8)(f) dramatically widens the impact of the foreign affiliate dumping rules. It was not present in the Initial Proposals and thus was not the subject of public comment. We question whether the impact of the rule has been studied in sufficient detail. Its inclusion should be carefully reconsidered. At a minimum, the new concept should not apply to transactions before August 14, 2012.

Paragraph 212.3(8)(f) provides that an "investment" in a SC made by a CRIC includes an acquisition by the CRIC of shares of the capital stock of another corporation resident in Canada ("**Canadian Target**"), of which the SC is a foreign affiliate, if the total FMV of all the shares that are owned directly or indirectly by the Canadian Target and are shares of foreign affiliates of the Canadian Target exceeds 50% of the total FMV (determined without reference to debt obligations of any Canadian corporation in which the Canadian Target has a direct or indirect interest) of all of the properties owned by the Canadian Target.

The Joint Committee had a vigorous debate about this rule. We note that it applies to a broad range of transactions, including major deals in capital markets and ordinary-course domestic transactions.

If it is intended that an investment in a Canadian Target be viewed as an “indirect” investment in underlying SCs, then this intention ought to be made clear in the text of the provision; mere assertions to that effect in the Explanatory Notes are inadequate.

As currently drafted, paragraph 212.3(8)(f) could apply inappropriately in situations where there is no additional investment in the underlying foreign affiliates. For example, suppose Canco1 (controlled by NR) owns all the shares of Canco2. Canco2 owns shares of FAs (accounting for greater than 50% of total FMV) but also has Canadian operations. Cash is required for the Canadian operations. Canco1 subscribes for additional shares of Canco2 and the cash is used by Canco2 in its Canadian operations. It seems that this results in a deemed dividend from Canco 1 to NR. This is completely inappropriate, as there has in fact been no additional investment in FAs, nor has there been any base erosion or indeed anything even approaching the perceived abuses meant to be curbed.

From a technical perspective, the parenthetical expression regarding liabilities refers only to those of a “Canadian corporation”. That term is narrowly defined in subsections 89(1) and 248(1). The narrow statutory definition seems inappropriate in the context of paragraph 212.3(8)(f).

Recommendation

Ultimately, we recommend that paragraph 212.3(8)(f) ought not to be enacted without a further public comment period and further detailed study as to the impact of this rule on Canadian capital markets and on the Canadian economy as a whole. Among other things to consider, we question the following:

- whether the rule is necessary or appropriate. We reiterate that the rule goes well beyond the Initial Proposals;
- whether the rule ought to be reformulated as a specific anti-avoidance rule. The policy objective could be more appropriately achieved by crafting a specific anti-avoidance rule that prevents the circumvention of the foreign affiliate dumping rules, or by relying on the existing general anti-avoidance rule (the “**GAAR**”);
- whether the 50% threshold is appropriate. In particular, consider structures whereby a foreign acquirer incorporates a Canadian acquisition vehicle to acquire a Canadian Target that owns an SC. This type of structure ought to be carved-out from the foreign affiliate dumping rules entirely. While the PUC reinstatement regime allows certain specific “bump and strip” transactions, these concessions are narrow, technical and provide pitfalls in respect of typical transactions that should not be considered to be offensive from a policy perspective. The traps and complexity of the new rules could discourage investment into Canada altogether;

- whether an investment in a Canadian Target by a CRIC ought to be exempted where the Canadian Target uses the proceeds in its Canadian business operations;
- whether public corporations ought to be carved-out from the ambit of the rule. Paragraph 212.3(8)(f) should exempt an acquisition of a CRIC that is a Canadian-resident public corporation in order to minimize the extent to which these sweeping rules interfere with capital market transactions. The FMV of the shares of such a CRIC may in many cases be attributable principally to its foreign affiliates. The foreign affiliate dumping rules could deter foreign multinationals from making an investment in such a CRIC, which could increase the cost of capital to major Canadian businesses (and diminish the market value of listed shares), all to the detriment of the domestic economy as a whole; and
- the exception for debts of any Canadian corporation in which the other corporation has a direct or indirect interest should be broadened beyond Canadian corporations.

(a) Subsection 212.3(10)

An anti-avoidance rule in subsection 212.3(10) deems paragraph 212.3(8)(f) to be satisfied for an acquisition by a CRIC of shares of a Canadian-resident corporation if:

- the Canadian Target disposes of property (other than shares of the FA) directly or indirectly after the time of acquisition as part of a series that includes the acquisition, and
- at any time after the acquisition but within the series, that same test would have been satisfied had the acquisition occurred at the subsequent time.

The anti-avoidance rule aims to prevent the Canadian Target from manipulating the relative proportions of “good assets” and “bad assets” in order to avoid meeting the test in paragraph 212.3(8)(f). However, any disposition of property by a Canadian Target within a series of transactions or events that includes an acquisition by the CRIC of shares of the Canadian Target falls within the ambit of the deeming rule in subparagraph 212.3(10)(a)(i). Due to the broad series concept embedded in the rule, there may be a requirement to value the property of the Canadian Target at every step of the series both before and after the relevant disposition of property by the Canadian Target. This rule should only require a valuation at the investment time at fair market value applicable at that time but excluding properties that are sold as part of the series, unless substituted with “non-SC” investments. Subsequent changes in value after the investment time should not be relevant.

In addition, valuations may be challenged as a factual matter. There should be some mechanism that permits the FP and the CRIC to make a late subsection 212.3(4) election to treat an unexpected deemed dividend effectively as a return of capital where the CRIC in good faith believed that the foreign affiliate dumping rules did not apply. Such a late election could be patterned on subsections 93(5) and (5.1), such that it may be made as of right within three years of the due date and thereafter at the discretion of the Minister of National Revenue.

Recommendation

For purposes of subsection 212.3(10), determination of FMV of the Canadian Target's shares of foreign affiliates and other property should be made only at the investment time (excluding properties that are sold as part of the series, unless substituted by assets other than investments in an SC), and not at every time throughout the series. A carve-out for dispositions of property in the ordinary course of business is also necessary to ensure that the rule does not apply inappropriately.

It would also be desirable to exclude "internal" dispositions between related CRICs, and to clarify the application of the rule with reference to "indirect dispositions".

Further, it should be possible to make a late-filed subsection 212.3(4) election.

7. Subsection 212.3(12)

Under the Initial Proposals, the BPE exempted from the foreign affiliate dumping rules an investment in an SC by a CRIC controlled by a FP if the investment could not reasonably be considered to have been made by the CRIC, rather than the FP (or another non-resident person not dealing at arm's length with the FP), primarily for *bona fide* purposes other than to obtain a tax benefit. The initial BPE set out a series of factors to be given primary consideration in applying the test.

While certain transactions qualify for an election to be governed by the Initial Proposals, for all other transactions, the revised BPE set out in subsection 212.3(12) applies. Under the revised BPE, certain of the "primary factors" that previously merely informed the determination of whether the investment in the SC "belonged" more to the CRIC than to the FP have become absolute and cumulative conditions. In this light, the revised BPE is stricter than its initial formulation. We believe that the revised BPE is far too restrictive and in practice will apply rarely. The assertion in the Explanatory Notes that the revised BPE may apply in a private equity context is, in our experience, not realistic. At the very least, the "closer connection" test should be changed to an "at least as closely connected" test.

The revised BPE contains three such conditions in paragraphs 212.3(12)(a) to (c).

a) Paragraph 212.3(12)(a)

The first condition requires the CRIC to demonstrate that the business activities of the SC directly or indirectly (determined on a look-through basis[13]) must be, at the investment time and thereafter, "on a collective basis more closely connected to the business activities carried on in Canada by the CRIC" (or another non-arm's length, Canadian-resident corporation) than to the business activities carried on by any non-resident corporation (other than the SC directly or

[13] The business activities of all corporations in which the SC has an "equity percentage" as defined in subsection 95(4) are to be taken into account.

indirectly, determined on a look-through basis[14]). This test will be very difficult (and in many cases impossible) to satisfy for the following reasons.

The revised BPE focuses on business activities carried on "in Canada" by a CRIC directly or indirectly. Therefore, the revised BPE would not be available if the CRIC is a holding company that does not carry on a Canadian business of its own (directly or indirectly). Where a CRIC is a holding company and wishes to make an investment in a SC linked to an existing business of a foreign affiliate of the CRIC, but which has no connection to the business of the FP, the revised BPE cannot be satisfied.

This may be the case where, for example, the CRIC is a public corporation that accesses capital markets in Canada to raise funds to invest in its foreign operations carried on by foreign affiliates. This structure arises often in the mining industry, where sophisticated foreign multinationals access Canada's highly developed capital markets to reduce their cost of capital.

In a similar vein, the revised BPE may not be available in the case of an investment in an SC by a CRIC pursuant to a financing structure. Where the SC provides financing to an operating foreign affiliate of the CRIC, or to a foreign affiliate of the CRIC that uses the funds to acquire another foreign affiliate, the "activities" of the SC consist of making loans. Depending on their extent and businesslike nature, these may (or may not) constitute "business activities." If they qualify as business activities, they must be considered "on collective basis" with the business activities of all corporations in which the SC has an "equity percentage."[15] This test does not allow the business activities of the ultimate borrower to be taken into account unless the SC has an equity percentage in that foreign affiliate. In a typical financing structure, this will often not be the case.

Further, the revised BPE is not available where the business activities of the SC are "equally" connected to those of the CRIC and the FP. The CRIC and the FP often will engage in the same line of business. Therefore, the revised BPE may not be available even if the CRIC would have made the investment as a strategic expansion had it not been controlled by the FP. This outcome is indefensible.

We also consider that the look-through approach is in some cases overbroad and in other cases too narrow. The business activities of the SC takes into account those of all other corporations in which the SC has an equity percentage. An SC may make equity portfolio investments with surplus funds. The business activities of these corporate investees would be included in the business activities of the SC, which could make it difficult for the CRIC to satisfy the revised BPE.

On the other hand, in assessing whether the business activities of the SC are more closely connected with the CRIC, the activities of all of the CRIC's foreign affiliates should be taken into account. Even where the CRIC carries on a business in Canada, the business activities of the SC may not be closely connected with that business but may be more closely connected with the business activities of the CRIC's other foreign affiliates, than with the business activities of

[14] *Ibid*.
[15] Defined in subsection 95(4).

the FP. Nonetheless, in such circumstances, the conditions in paragraph 212.3(12)(a) cannot be satisfied. In characterizing the connection, the activities of the CRIC and its foreign affiliates on a collective basis should be considered.

Recommendation

The revised BPE should apply if the business activities of the SC are on a collective basis at least as closely connected to the business activities carried on by the CRIC in Canada or elsewhere (such as a foreign branch) directly or indirectly (on a look-through basis taking into account the business activities of the CRIC's foreign affiliates) than to the business activities carried on by any non-resident corporation (other than the SC directly or indirectly, determined on a look through basis).

Further, if the revised BPE would have applied where a CRIC makes an investment directly in an SC that is an operating foreign affiliate or an acquisition vehicle to acquire an operating non-resident corporation, then the CRIC should be entitled to finance that investment through a typical financing structure without engaging the foreign affiliate dumping rules.

b) Paragraphs 212.3(12)(b) and (c)

Paragraphs 212.3(12)(b) and (c) seek to identify the strength of the nexus between Canadian officers of the CRIC and the business of the SC in order to determine whether the business of the SC is more closely connected to the business activities carried on by the CRIC than to those of the FP. We believe that these tests are misguided because they do not determine whether the investment in the SC erodes the Canadian tax base.

In this light, paragraphs 212.3(12)(b) and (c) pose the same inquiry as paragraph 212.3(12)(a), a more general provision. Therefore, it is arguable that paragraphs 212.3(12)(b) and (c) are superfluous.

A more serious concern is that paragraphs 212.3(12)(b) and (c) do not contemplate a functional management organization popular amongst multinationals. The FP may not organize its management along geographical lines. It will be very difficult to satisfy the revised BPE where the CRIC does not operate autonomously, which is often the case.

Paragraph 212.3(12)(c) requires, at the investment time, a reasonable expectation that:

- the officers of the CRIC will have and exercise the ongoing principal decision-making authority in respect of the investment;
- a majority of those officers will be resident and work principally in Canada; and
- the performance evaluation and compensation of the officers of the CRIC who are resident and work principally in Canada will be based on the result of operations of the SC to a greater extent than will be the performance evaluation and compensation of any officer of a non-resident corporation (other than the SC or a corporation controlled by the SC) that does not deal at arm's length with the CRIC.

The residence and work location of officers of the CRIC may not be indicative at all of the nexus of the CRIC's investment in the SC with Canada as a whole. On occasion, an officer of the CRIC will be involved in the management of the SC in which the CRIC invests and may be required to reside and work principally in a foreign jurisdiction. In other cases, the investment may be fully managed by officers of the CRIC but those officers may reside and work principally outside of Canada.

Further, in the absence of contingent compensation that turns on the performance of the SC, the test in subparagraph 212.3(12)(c)(iii) may be impossible to meet.

In addition, the focus of the inquiry is on the CRIC's investment in the SC. However, that investment may be substituted or exchanged at some point in the future. The tests in paragraph 212.3(12)(c) ought to take into account any such substitution or exchange.

Recommendation

We recommend the following:

- reformulate the BPE as an exemption from the application of the foreign affiliate dumping rules for transactions that do not erode the Canadian tax base, as suggested in our prior Submission; and
- omit paragraphs 212.3(12)(b) and (c). In the alternative, drop the requirement for officers of the CRIC to be resident and work principally in Canada.

8. Subsection 212.3(13)

Subsection 212.3(13) exempts from the ambit of the foreign affiliate dumping rules in subsection 212.3(2) certain acquisitions of shares of the SC through certain reorganization and distribution transactions falling into one of three categories:

- an acquisition of shares of a SC made by a CRIC from another corporation resident in Canada to which the CRIC is related immediately before the investment time and that does not deal at arm's length with the CRIC at any time before the investment time and within the series that includes the making of the investment;
- an acquisition of shares of a SC made by a CRIC that arises as a result of a tax-deferred amalgamation[16] of two or more corporations to form the CRIC if all of the predecessor corporations are related immediately before the amalgamation and none of the predecessor corporations deals at arm's length with another predecessor corporation at any time before the investment time and within the series that includes the making of the investment; and
- an acquisition of shares of a SC made by a CRIC by virtue of certain specified types of transactions, including certain share exchanges, foreign mergers and liquidations and certain distributions.

[16] Subsection 87(1).

These exceptions apply only in respect of an acquisition of shares of an SC by a CRIC. They do not apply to an acquisition of indebtedness or any other interest in the SC such as an option. Moreover, they do not apply where the property is acquired in a transaction described in paragraph 212.3(8)(f). There does not appear to be a policy reason that justifies such a limited scope for the reorganization exception.

The reorganization exception should also exempt completely any substitution for an investment in an SC made by a CRIC that previously triggered the application of subsection 212.3(2). This extension is necessary to avoid multiple applications of the foreign affiliate dumping rules.

a) Paragraph 212.3(13)(c)

Paragraph 212.3(13)(c) is too narrow. In particular, the provision does not exempt a recapitalization of an SC by a CRIC in respect of indebtedness and equity existing on March 28, 2012. From a policy perspective, the capitalization of existing debt into equity (and *vice versa*) should not be objectionable.

In addition, in respect of subparagraph 212.3(13)(c)(ii), subsection 212.3(2) does not apply to an investment in an SC made by a CRIC if the investment is an acquisition of shares of the SC as consideration for a disposition of shares to which subsection 85.1(3) applies. If there is a resulting loss on the foreign share-for-foreign share exchange, paragraph 85.1(4)(b) provides that subsection 85.1(3) no longer applies. In that case, the exemption would not be available.

Recommendation

We recommend the following:

- broaden the reorganization exception in subsection 212.3(13) to cover any “investment” in a SC by a CRIC that falls within the ambit of paragraphs 212.3(8);
- revise paragraph 212.3(13)(b) to address issues raised in Appendix B and to apply to exchanges of debt and other investments on an amalgamation;
- a gain or loss is realized on the disposition should be irrelevant to the application of the reorganization exemption; and
- the reorganization exemption should exempt an acquisition of shares of an SC where the investment is temporary and is not owned by the CRIC or any non-arm’s length, Canadian-resident corporation within 30 days of the investment time.

9. Subsection 212.3(14)

Under the Initial Proposals, one factor to be given primary consideration in applying the initial BPE was whether the shares of the SC were fully participating.

Under subsection 212.3(14), this factor became an absolute condition that must be satisfied in order to rely on the revised BPE and the reorganization exception. More specifically, these exceptions do not apply to an acquisition of shares of an SC by a CRIC if those shares are not fully participating unless the SC is a wholly-owned subsidiary of the CRIC.

Denial of these exceptions in the case of preferred shares overreaches the rule's objective. A CRIC may make a strategic expansion jointly with an arm's length person by each investing in shares of an SC. In that situation, the foreign affiliate dumping rules could restrict flexibility in structuring the capital structure of the SC. To the extent that the investment in the SC by the CRIC otherwise complies with subsection 212.3(12), it is difficult to see why the CRIC could not acquire preferred shares in the SC in proportion to those acquired by the other participant in the joint venture, and in proportion to their ownership of common shares.

Further, the exception in subsection 212.3(14) is too narrow. In particular, there is no relief afforded where the SC is an indirectly wholly-owned subsidiary of the CRIC.

Recommendation

Subsection 212.3(14) should carve-out an investment in preferred shares of an SC by a CRIC where the investment is proportional to those of the other shareholders of the SC and proportional to its investment in the common shares of the SC.

Further, subsection 212.3(14) should not apply where the SC is wholly owned on a collective basis by the CRIC and non-arm's length, Canadian-resident persons. The definition of "subsidiary wholly-owned corporation" is too narrow for this purpose.

10. Transitional Rules

Under the transitional rules, subject to filing an election to apply the rules as proposed on Budget Day, the rules apply to transactions and events that occur after Budget Day. The rules do not apply to transactions occurring before 2013 between parties that deal at arm's length if the parties are obligated to complete the transactions under the terms of the written agreement. There is no good reason for limiting grandfathering to transactions that closed before 2013 where there was a legally binding agreement on Budget Day.

Most agreements in writing provide conditions to closing such as regulatory approval or material adverse change provisions that may be outside the control of the party making the investment.

Recommendation

We recommend the following:

- provide transitional relief to agreements entered into before budget date that are legally binding rather than linking to the completion of the transaction; and

- extend relief to non-arm's length "investments" that are made to consummate an arm's length transaction for which there was a binding agreement on Budget Day.

11. Transitional Election

The Legislative Proposals include a transitional election under which a taxpayer may elect to have the Initial Proposals apply to transactions that occur from March 29, 2012 to August 13, 2012, inclusive.

A taxpayer may need to make this transitional election if a CRIC made an "investment" in an SC that was not caught by the Initial Proposals (such as an extension of debt or an investment in a Canadian Target). During that interim period, taxpayers may well have concluded reasonably that proper reorganization exceptions would be included in the Legislative Proposals (indeed, this was confirmed in remarks made by representatives of the Department of Finance (Canada) at a conference of the International Fiscal Association in May of 2012, and there was no suggestion in those remarks that these rules would be inapplicable where a taxpayer relied on the Initial Proposals). Yet, one consequence of making the transitional election to apply the Initial Proposals is that the taxpayer would not be entitled to rely on the reorganization rules in subsection 212.3(13). This is unfair. The expansion of the rules to debt extensions and indirect acquisitions was unexpected.

Recommendation

Taxpayers should have the benefit of the reorganization exceptions effective as of March 29, 2012, whether or not they make the transitional election.

II. Thin Capitalization

A. Paragraph 12(1)(l.1)

Paragraph 12(l)(*l*.1) is intended to require a corporation that is a member of a partnership to include in its income an amount equal to its share of the interest payable on a debt of the partnership allocated to the corporation under proposed subsection 18(7) to the extent that the allocated debt exceeds the corporation's permitted debt-to-equity ratio for purposes of the thin capitalization rules and is debt owing to a specified non-resident in relation to the corporation. The Explanatory Notes explain that the relevant period for computing interest is the corporation's taxation year, rather than the fiscal period of the partnership. However, as currently drafted the rule may result in the interest being included in the corporation's income in both the taxation year in respect of which the interest is payable and the taxation year in respect of which it is actually paid. This problem may be illustrated by the following example.

Assume PartnerCo, a taxable Canadian corporation with a taxation year end of June 30, is a member of Partnership which has a December 31 fiscal period end. Partnership has incurred indebtedness to a specified non-resident shareholder of PartnerCo and interest on that indebtedness is payable annually on December 31 of each year. In computing its income for its taxation year ending June 30, 2013, it appears that proposed paragraph 12(1)(*l*.1) requires

PartnerCo to include in its income both the interest paid in that taxation year (i.e., the interest paid on December 31, 2012 in respect of the January 1-December 31, 2012 period), and the interest payable by Partnership in respect of the period January 1, 2013 to June 30, 2013. Similarly, in its taxation year ending June 30, 2014, PartnerCo is required to include in its income the interest paid on December 31, 2013 for the 12-month period then ended and the interest payable for the period January 1, 2014 to June 30, 2014.

It is also not clear from the legislation that the debt amount must be included in the taxpayer's outstanding debt in the taxation year in respect of which the interest is payable.

Further, the amendments to the thin capitalization rules propose to include in a corporate partner's income an amount equal to the interest on the portion of the allocated partnership debt that exceeds the permitted debt-to-equity ratio. Because this income is not partnership income which is allocated under section 96, there is no adjustment under subsection 53(1) to the adjusted cost base of the partnership interest in respect of the income inclusion. This income is a proxy for partnership interest expense that would otherwise be denied. If the partnership allocates a loss for the year to the corporate member (which loss is in whole or part attributable to such interest expense) and the loss is restricted by the at-risk rules, a mismatch could occur.

Recommendation

We recommend that:

- subclause A(ii) be amended to read as follows:

  (ii) payable by the partnership in respect of, or, paid by the partnership in <u>(depending on the method regularly followed by the taxpayer in computing the taxpayer's income)</u>, the taxation year of the taxpayer on a debt amount included in the taxpayer's outstanding debts to specified non-residents (as defined in subsection 18(5)) <u>in such taxation year</u>.

- the at-risk rules be amended so that partnership losses are not affected to the extent of the corporate member's proxy income for the year.

III. EPSPs

Section 207.8 generally imposes a tax on excessive allocations to specified employees under an EPSP. The tax applies to an "excess EPSP amount,"[17] which generally represents the portion of the employer's total contributions to an EPSP that is allocated to the taxpayer for the year and that exceeds 20% of the taxpayer's total other employment income received in the year from the employer. The special tax can be waived or cancelled in certain circumstances.

[17] Defined in subsection 207.8(1).

Under paragraph 8(1)(o.2), a taxpayer may deduct in computing employment income his or her "an excess EPSP amount." However, it appears that the excess EPSP amount is excluded from earned income for purposes of computing contribution room to a registered retirement savings plan ("**RRSP**"), despite that it has been subject to the special tax.

Recommendation

Allow the amount of the deduction under paragraph 8(1)(o.2) to be included in computing "earned income" for RRSP purposes.

IV. Partnerships

A. Subparagraph 88(1)(d)(ii.1)

Subparagraph 88(1)(d)(ii.1) is intended to reduce the fair market value of a partnership interest for purposes of determining the amount by which the adjusted cost base of the partnership interest can be "bumped" on a winding-up of a subsidiary. Variables A and B of subparagraph 88(1)(d)(ii.l1) both refer to the fair market value of the partnership interest at the time the parent last acquired control of the subsidiary but only variable A includes the parenthetical phrase "(determined without reference to subparagraph 88(1)(d)(ii.1))". The Explanatory Notes suggest that the fair market value in each of variables A and B are intended to be the same (*i.e.*, in each case determined without reference to subparagraph 88(1)(d)(ii.1)).

Recommendation

Reword proposed variable B to read as follows:

> B is the portion of the amount by which the fair market value of the interest at the time the parent last acquired control of the subsidiary <u>(determined without reference to subparagraph 88(1)(d)(ii.1))</u> exceeds its cost amount as may reasonably […]

B. Paragraph 88(1)(e) and Subsection 97(3)

Each of paragraph 88(1)(e) and subsection 97(3) are described in the Explanatory Notes as anti-avoidance rules intended to preclude transactions that might be undertaken to avoid the bump limitation rule in subparagraph 88(1)(d)(ii.1).

In the case of paragraph 88(1)(e), the Explanatory Notes state: "Paragraph 88(1)(e) is meant to address transfers of property…(during the series of transactions in which control is acquired*<u>) in circumstances where the transfers are made to change the factors that may be relevant when applying the formula in subparagraph 88(1)(d)(ii.1)</u>*". In the case of subsection 97(3), they state: "This anti-avoidance rule is meant to ensure that …[ineligible property] is not transferred on a tax-deferred basis…*<u>in circumstances that would seek to frustrate the purpose of new subparagraph 88(1)(d)(ii.1)</u>*."

As an initial observation, while we acknowledge that Explanatory Notes can be a helpful guide to interpretation, they cannot be a substitute for statutory language that reflects the intention of Parliament. Subsection 97(3) is particularly troubling in this regard. It is extremely broadly drafted and the two related examples in the Explanatory Notes do not provide any guidance as to why the provision might apply; there is no explanation in the examples as to how the transaction might frustrate the purpose of subparagraph 88(1)(d)(ii.1). As a consequence, it is impossible to identify the anti-avoidance concern. Examples that are intended to illustrate the scope or objective of the rule must clearly identify how the transactions frustrate the purpose of subparagraph 88(1)(d)(ii.1).

The GAAR could be applied to transactions undertaken to undermine the intended application of subparagraph 88(1)(d)(ii.1). However, if it is considered necessary to augment the GAAR with specific anti-avoidance rules, it is imperative that the anti-avoidance nature of the provision be evident from its statutory language and that such language delineate the scope of its application. Neither paragraph 88(1)(e) nor subsection 97(3) is identified in the Legislative Proposals as an anti-avoidance rule and neither such provision implicitly or expressly indicates its purpose or intended scope. We believe it is inappropriate to draft a specific anti-avoidance rule with statutory language that gives no indication of its purpose or the context in which it is to be applied. The only hint at the anti-avoidance nature of the provisions is found in the Explanatory Notes, which are particularly inadequate in the context of proposed subsection 97(3). As drafted, subsection 97(3) applies to a transfer of property to a partnership regardless of whether that partnership interest is itself the subject of a designation under paragraph 88(1)(d). This is inconsistent with the Explanatory Notes which state: "the parent makes a designation under paragraph 88(1)(d) in respect of an interest in ***the*** partnership", in contrast to proposed paragraph 97(3)(a)(iii) which merely requires the parent to make a designation under paragraph 88(1)(d) in respect of an “interest in ***a*** partnership:. We assume that the Explanatory Notes express the intended scope but the statutory language must be made consistent with that intention.

Moreover, the partnership to which the property is transferred need not be a partnership in which the subsidiary is directly or indirectly a member. It is not clear that transfers of property following the winding up of the subsidiary are exempted.

The breadth of the provision may be illustrated by considering the second example in the Explanatory Notes. Assume that, instead of transferring property to Partnership ABC, as part of the series of transactions in which control of the subsidiary is acquired, Corporation Y transfers property to Partnership XYZ in reliance on subsection 97(2). Subsection 97(3) would render subsection 97(2) inapplicable notwithstanding that there is no designation possible in respect of an interest in Partnership XYZ, that the transfer has no effect on the nature of the assets owned by Partnership ABC, and that the limitation in proposed subparagraph 88(1)(d)(ii.1) applies exactly as it should. Subsection 97(3) would apply whether the transfer to Partnership XYZ occurred before or after the subsidiary is wound up because before the disposition the subsidiary has an interest in Corporation Y and thus the test in (d) is met.

We believe it is imperative that a specific anti-avoidance rule expressly identify the nature of the anti-avoidance concern and strongly believe that both provisions, if retained, should be revised to reflect their intended scope.

At a minimum, subsection 97(3) should be limited to transfers of property to a particular partnership where the subsidiary has an interest in that partnership, either directly or indirectly through another partnership (but <u>not</u> through a corporation – looking through a corporation appears inconsistent with statements in the Explanatory Notes that assets can be transferred into a corporation on a tax-deferred basis); the subsidiary's interest in the particular partnership (or the subsidiary's interest in the partnership through which the subsidiary holds an interest in the particular partnership) is the subject of a designation under paragraph 88(1)(d); and the disposition occurs before the subsidiary is wound-up or amalgamated

Recommendation

Paragraph 88(1)(e) and subsection 97(3) should be amended to include a reference to the anti-avoidance nature of the provisions and the nature of the transactions that are intended to be subject to the provisions.

For example, paragraph 88(1)(e) might be amended by adding something like the following as (iii):

> (iii) where it is reasonable to consider that one of the purposes of the disposition of property described in (i)(A) or the acquisition of the partnership interest described in (i)(B) is to affect the factors that may be relevant when applying the formula in subparagraph 88(1)(d)(ii.1)

and subsection 97(3) might be amended by adding something similar as paragraph (e).

At a minimum, proposed subsection 97(3) should be limited to transfers of property to partnerships interests in which are the subject of a designation under paragraph 88(1)(d) or to partnerships of which such a partnership is a member. In particular, proposed subparagraph 97(3) should be amended to read as follows:

> (3) Subsection (2) does not apply to a disposition of property to a particular partnership if
>
> (a)…
>
> (iii) the parent makes a designation under paragraph 88(1)(d) in respect of an interest in <u>the particular</u> partnership <u>or in respect of an interest in a partnership through which the subsidiary, directly or indirectly through one or more partnerships, holds an interest in the particular partnership</u>;
>
> (b) the disposition occurs after the acquisition of control of the subsidiary <u>and before the winding-up of the subsidiary or the amalgamation of the subsidiary described in subparagraph (a)(ii)</u>;

(d) the subsidiary is the taxpayer or <u>holds, immediately after</u> the disposition of the property, <u>directly or indirectly through one or more partnerships, an interest in the particular partnership</u>.

C. Section 100

Subsection 100(1.3) provides that subsection 100(1) will not apply to a taxpayer's disposition of an interest in a partnership to a non-resident person if the property of the partnership is used, immediately before and immediately after the acquisition of the interest by the non-resident person, in carrying on business through one or more permanent establishments in Canada where the total fair market value of that property is at least 90% of the total fair market value of all of the property of the partnership (determined without reference to liabilities). We submit that this exception is too narrow.

In particular, it should apply where the transferor is also a non-resident, irrespective of the composition of the assets of the partnership. Paragraph 100(1.3)(a) should also apply to other forms of Canadian property that is taxable to non-residents on disposition, such as real property in Canada (whether or not held as part of a business) and Canadian resource property. Finally, the 90% safe harbour should also include capital properties that would not themselves cause subsection 100(1) to apply in the first place. For example, a partnership uses 50% of its assets in a Canadian business and the other 50% relates to the ownership of shares of a subsidiary. As written, the exception in subsection 100(1.3) does not apply, even though no issue would arise if the partnership had instead owned 100% Canadian business assets or 100% shares.

Recommendation

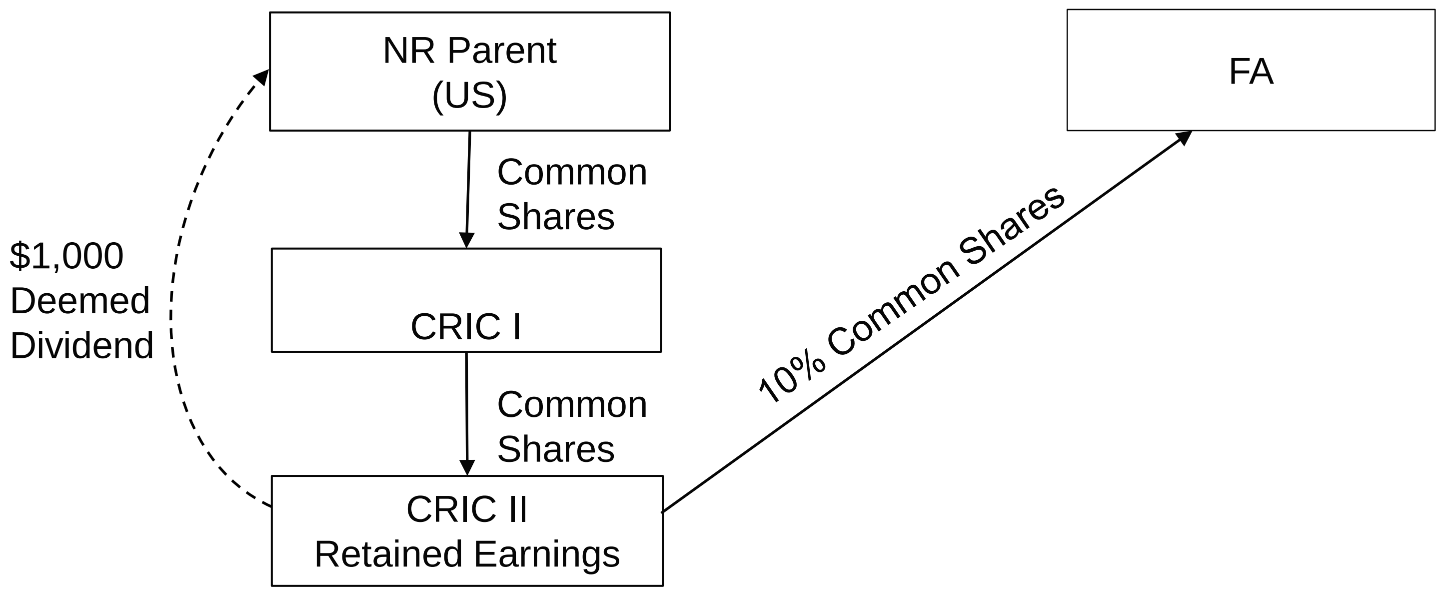
Broaden the exception in subsection 100(1.3).

Appendix A
Examples of Anomalies under the Foreign Affiliate Dumping Rules

Appendix A

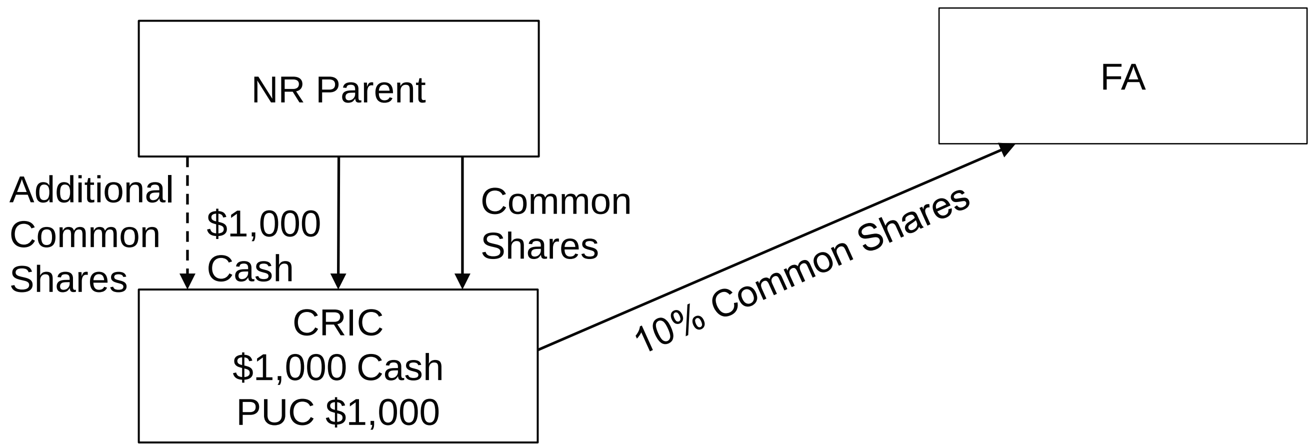
Examples

Example 1 – Double-Stacked Structure – Use of Retained Earnings



- CRIC II acquires 10% of FA's common shares for cash of $1,000 from its retained earnings from third party or from FA.
- Dividend of $1,000 deemed to be paid by CRIC II to NR Parent.
- Dividend withholding tax rate is 15% under the *Canada-U.S. Tax Treaty* – if CRIC I had acquired the FA common shares the dividend withholding tax rate would have been 5% under the *Canada-U.S. Tax Treaty* assuming NR beneficially owns the dividend

Example 2 – Electing Out of Deemed Dividend – One Class of Shares/More Than One Class of Shares



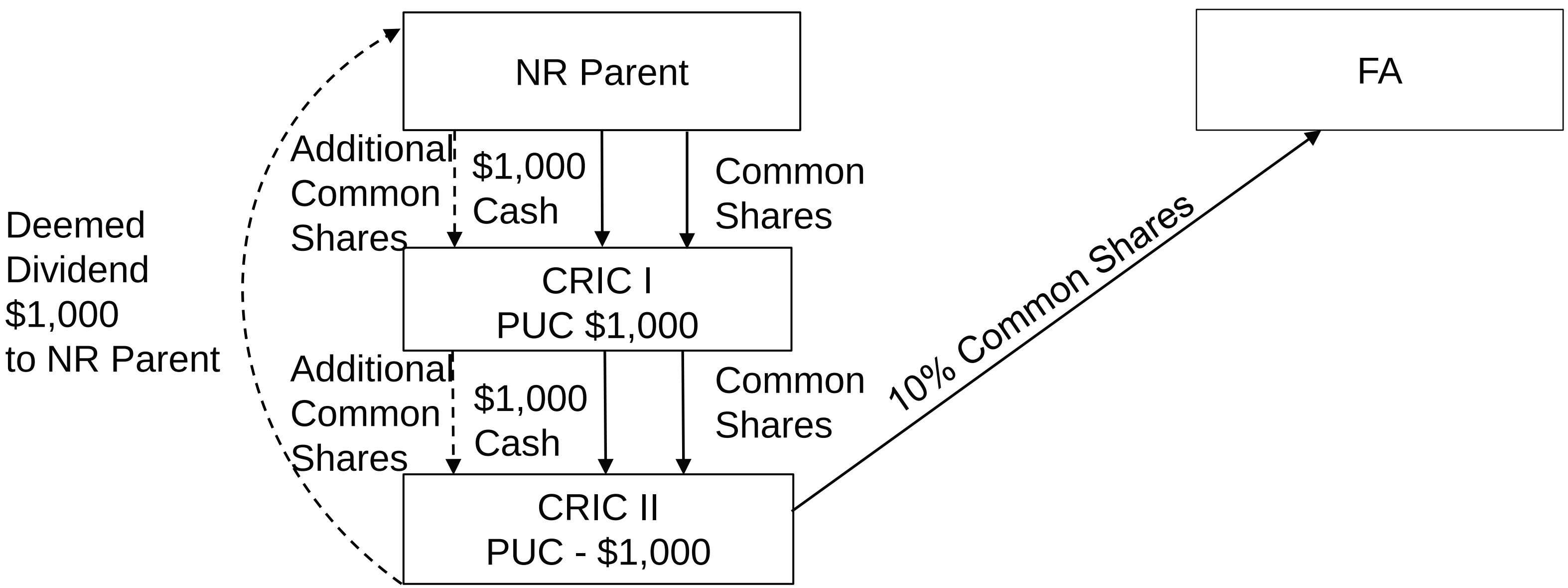
- NR Parent subscribes for additional common shares of CRIC for cash of $1,000.
- PUC of common shares of CRIC is increased by $1,000.
- CRIC uses cash of $1,000 to acquire 10% of the common shares of FA from FA or from third party.
- The acquisition of the FA shares triggers a deemed dividend from CRIC to NR Parent subject to withholding tax.

Example 2 – (Cont'd)

•**Exception**

- CRIC and NR Parent can elect to reduce the deemed dividend which triggers an equal PUC reduction (subsection 212.3(5)).
- Where the CRIC has more than one class of issued shares, the dividend is reduced to the extent that the property used to increase the PUC of all classes can be traced to the investment in the FA and the PUC of each class is reduced by the amount of property from that class that was so used.
- Where there is only one class of shares tracing is not required but the dividend and PUC reductions cannot exceed the PUC of that class.
- This election is available only if any CRIC shares not owned by NR Parent are owned by persons who deal at arm's length with the CRIC; so even if one share held by affiliate of NR, no PUC suppression is available – why set this trap?

Example 3 – No PUC Suppression – Double-Stacked

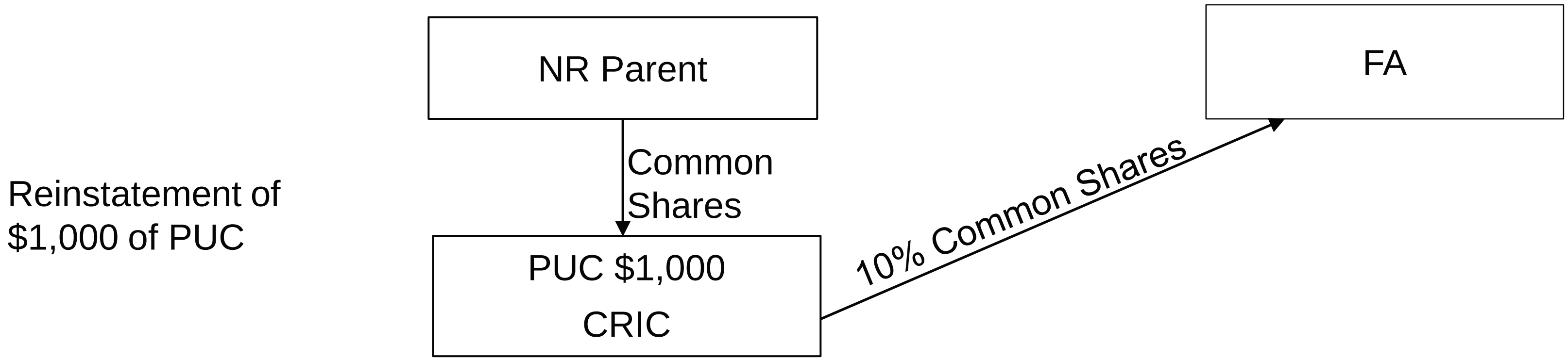


- NR Parent subscribes for additional common shares of CRIC I for $1,000 cash.
- Subscription creates PUC of $1,000 in CRIC I.
- CRIC I subscribes for additional common shares of CRIC II for $1,000 cash.

Example 3 – (Cont'd)

- Creates PUC of $1,000 in CRIC II.
- CRIC II acquires FA common shares for $1,000 cash from FA or NR Parent => deemed dividend
- Cannot reduce deemed dividend by suppressing PUC under subsection 212.3(5) because CRIC I is a shareholder of CRIC II that does not deal at arm's length with CRIC II.
- Therefore cannot eliminate deemed dividend of $1,000 from CRIC II to NR Parent by PUC suppression. How can different result from Example 2 be justified?

Example 4 – PUC Reinstatement Rule



- The PUC reinstatement rule applies where the "investment" in the FA was FA shares, the PUC suppression election was made and at a subsequent time the CRIC distributes the FA shares or the proceeds from the sale of those FA shares (within 30 days of the sale) to NR Parent as a “PUC” (presumably stated capital) reduction.
- The PUC reinstatement rule (subsection 212.3(7)) automatically reinstates immediately before distribution, the PUC of the CRIC shares that was previously suppressed.

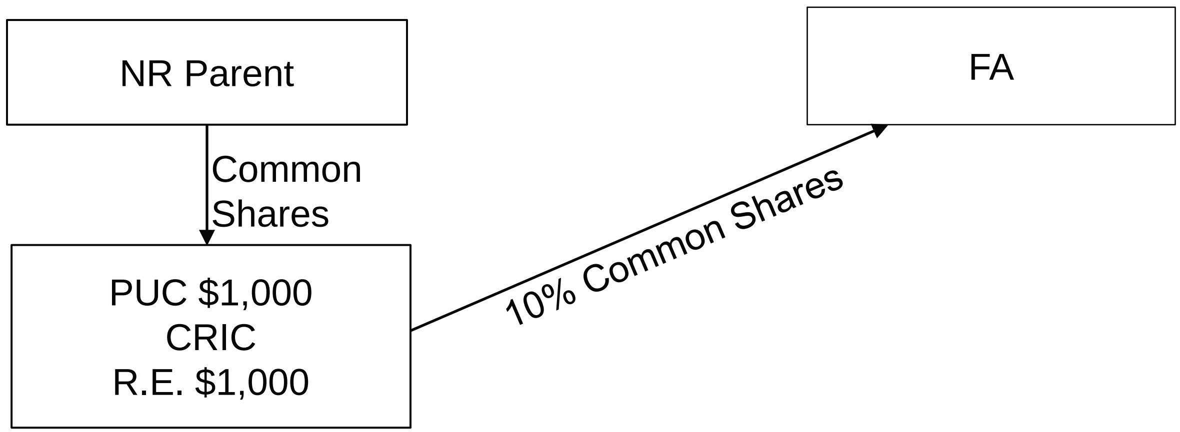
Example 4 – (Cont'd)

- This permits the FA shares or their sale proceeds to be returned to NR Parent as a tax-free PUC reduction at least to the extent of the initial value of the FA shares when they were acquired by the CRIC where the CRIC is wholly-owned by NR Parent.
- Any excess value in the FA shares or their sale proceeds is deemed to be a dividend subject to withholding tax.
- The PUC suppression reinstatement provisions permit NR Parent to use the CRIC as a conduit to acquire shares of an FA.
- *Note:* If CRIC has more than one class of shares – need to trace cash invested in CRIC shares to FA shares for PUC suppression and reinstatement.
- *Note:* If CRIC has one class of shares – no tracing required for PUC suppression and reinstatement.
- How to justify the different treatment – especially if multiple classes and a single shareholder?

Example 4 – (Cont'd)

- Where the CRIC has more than one shareholder, the reinstated PUC of a class of shares is averaged over all the shares of the class – therefore, where CRIC has more than one shareholder, NR Parent will need to subscribe for a separate class of shares to ensure the reinstated PUC is attributed to shares held by NR Parent to permit NR Parent to recoup cash invested if FA shares are sold.

Example 5 – Retained Earnings Used to Acquire Common Shares of FA for Cash from Retained Earnings – Elect out of Deemed Dividend – One Class of Shares

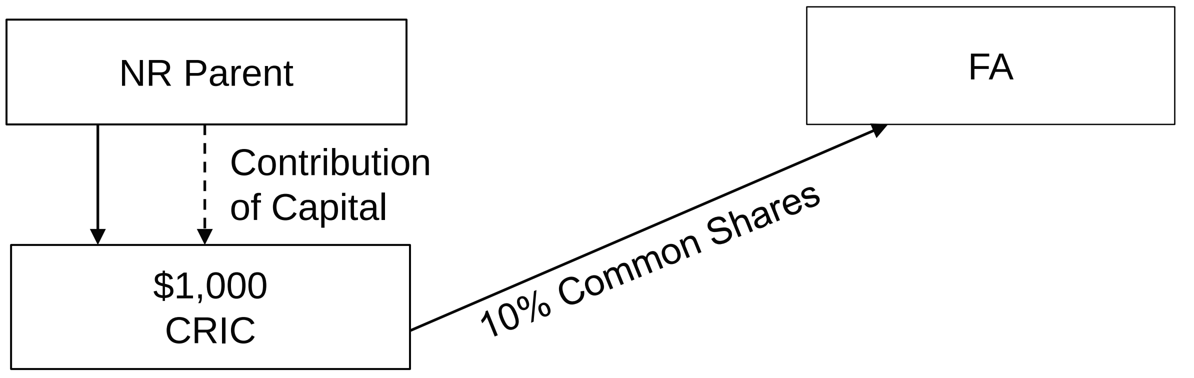


- CRIC has PUC of $1,000.
- CRIC uses $1,000 of retained earnings to acquire FA shares from third party or from FA.
- Deemed dividend of $1,000 from CRIC to NR Parent.

Example 5 – (Cont'd)

- But CRIC and NR Parent can elect to suppress CRIC's existing PUC of $1,000 to eliminate deemed dividend if CRIC has only one class of shares (subsection 212.3(5)). PUC suppression would <u>not</u> work if >1 class of shares in CRIC – how can this be justified?
- If FA shares or their sale proceeds are distributed to NR Parent by CRIC (sale proceeds within 30 days of sale) as a return of "PUC" – PUC of $1,000 automatically added to PUC of single class of shares immediately before distribution – (PUC reinstatement rule in s. 212.3(7)).

Example 6 – Contribution of Capital by NR Parent to CRIC

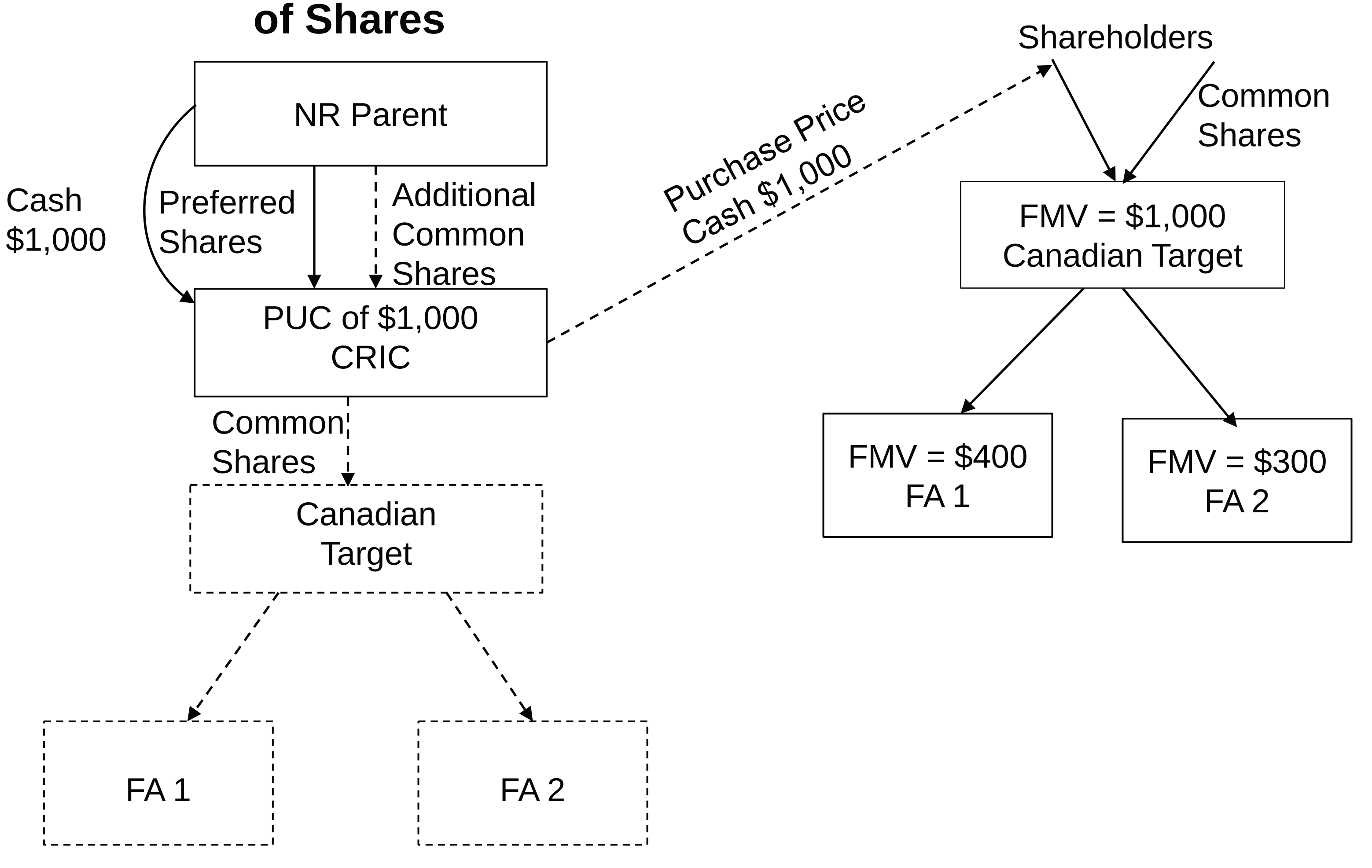


- NR Parent contributes capital of $1,000 to CRIC which CRIC uses to acquire common shares of FA for $1,000.
- The acquisition results in a deemed dividend of $1,000.
- Arguably, no PUC is created on the contribution of capital (on the basis the surplus arises "in connection with" an investment to which 212.3(2) applies) -- notwithstanding that NR Parent did not appropriate an asset belonging to the CRIC but instead contributed an asset to the CRIC.

Example 6 – (Cont'd)

- The rules which normally would permit the contributed surplus to be converted into PUC without triggering a deemed dividend arguably do not apply to contributed surplus that arose in connection with an investment to which the rules in subsection 212.3(2) apply – this may be unintended; if so, should be clarified
- It follows that the FA common shares or their sale proceeds can only be returned to NR Parent as a dividend.
- Two dividends – one immediate and one deferred.
- In addition, the contributed surplus is not recognized for the purposes of the thin capitalization rules.

Example 7 – Canadian Target with FAs – CRIC has More than One Class of Shares



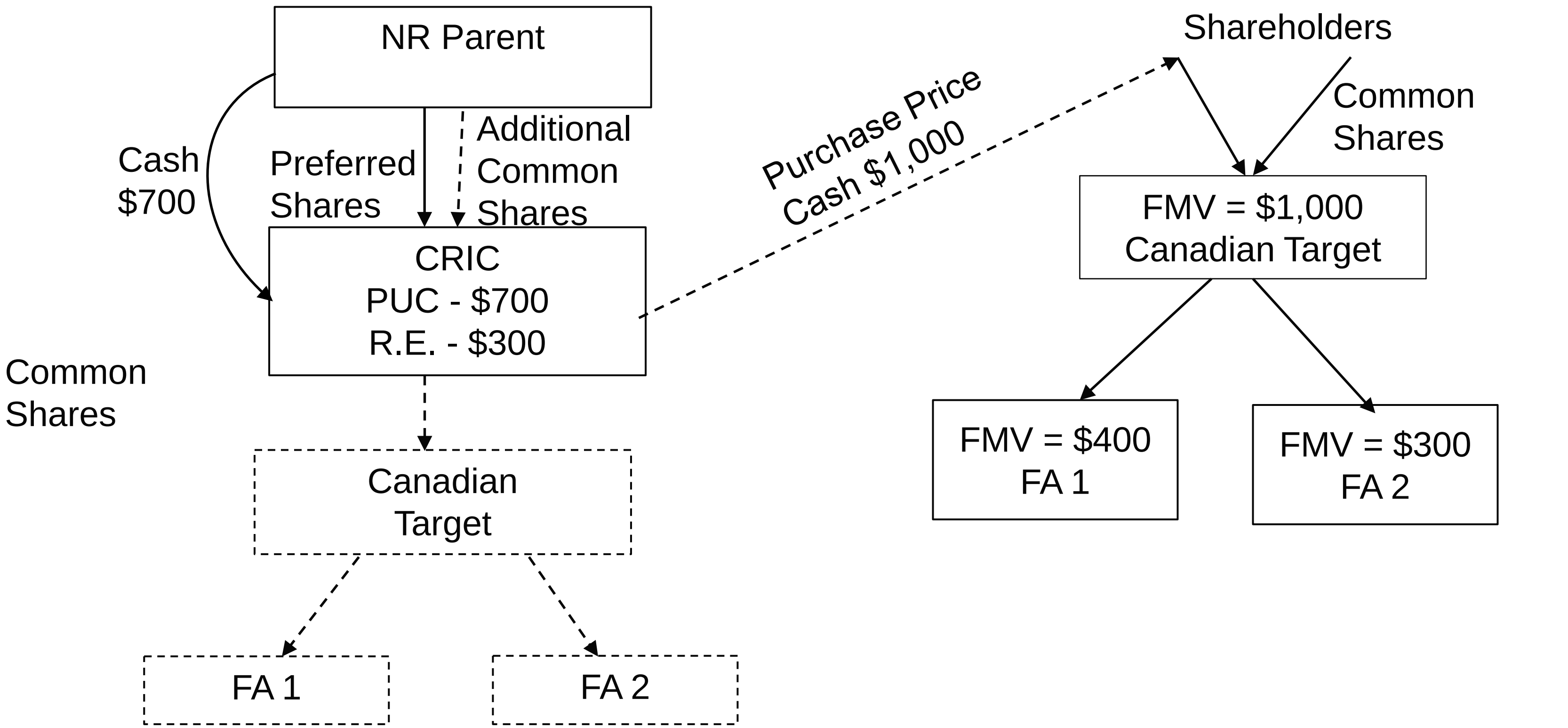
Example 7 – (Cont'd)

- NR Parent subscribes for additional common shares of CRIC for cash of $1,000.
- CRIC uses the $1,000 to purchase the shares of Target.
- If the total FMV of FA 1 and FA 2 exceeds 50% of FMV of all properties of Target, the acquisition by the CRIC of shares of Target is treated as an acquisition by the CRIC of FA 1 and FA 2 for the purposes of the deemed dividend rule in subsection 212.3(2).
- Since we have assumed that the FMV of FA 1 is $400 and the FMV of FA 2 is $300, their aggregate FMV is $700 and therefore the combined FMV of the FAs exceeds 50% of the total FMV of Target of $1,000.
- The acquisition of Target is treated as an acquisition by CRIC of FA 1 for $400 and of FA 2 for $300 for the purposes of the deemed dividend rule.

Example 7 – (Cont'd)

- This results in a dividend of $700 deemed paid by the CRIC to NR Parent subject to withholding tax.
- Since NR Parent subscribed for additional shares of CRIC for cash of $1,000, the PUC of those shares increased by $1,000 (though 212.3(2)(a) should be clarified to produce this intended result).
- NR Parent and CRIC can elect to suppress the PUC and reduce the deemed dividend to nil.

Example 8 – Canadian Target with FAs – II – CRIC has More than One Class of Shares

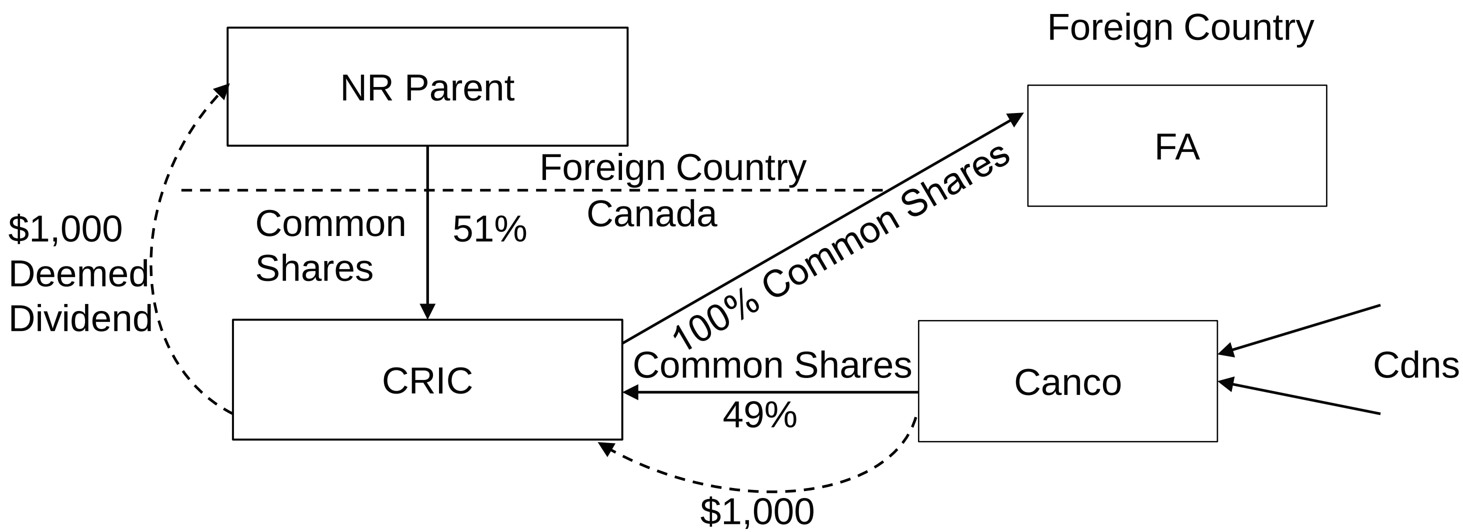


- Purchase price of $1,000 is funded by $700 out of PUC of CRIC and $300 out of retained earnings of CRIC.

Example 8 – (Cont'd)

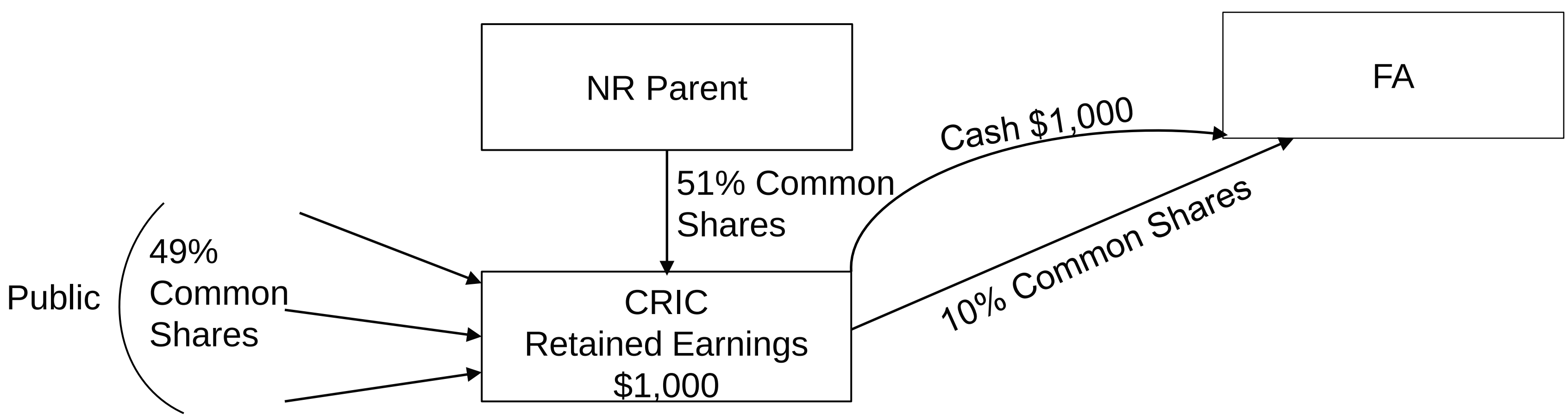
- For PUC suppression rule – need to trace acquisition cost of FA 1 and FA 2 to PUC if more than one class of shares.
- Cost of FAs could be $700 out of PUC and $0 out of R.E. or $400 out of PUC and $300 out of R.E. or $500 out of PUC and $200 out of retained earnings – no way to tell since money is fungible and all that is actually being acquired is shares of Target.
- If PUC was $500 and R.E. was $500 then minimum from PUC is $200 (i.e., $700 minus R.E. of $500).
- What would be the result if the CRIC acquired the shares of Target partially for cash of, say, $200 and CRIC shares having a value of $800?
- There is no allocation rule to determine the amount of PUC used to acquire the Target shares that can be considered to be used to acquire the FA shares – this is a gap that should be fixed so rule can be applied.
- If CRIC has only one class of shares, then no allocation problem – suppress PUC of CRIC by FMV of the shares of FA 1 and FA 2 or $700 to eliminate deemed dividend of $700.

Example 9 – Canadian Minority Investment in CRIC



- Canco is controlled by Canadian residents and invests $1,000 in CRIC shares for 49% of the CRIC.
- CRIC invests $1,000 in FA shares.
- Deemed dividend to NR Parent only of $1,000 unless NR Parent (not Canco) and CRIC make the PUC suppression election to eliminate the dividend. Inappropriate result. Canco would take position PUC should not be suppressed.
- If PUC suppressed, PUC reduction averaged over all shares, so affects both shareholders.

Example 10 – Retained Earnings Used to Acquire Common Shares of FA Where More Than One Shareholder of CRIC



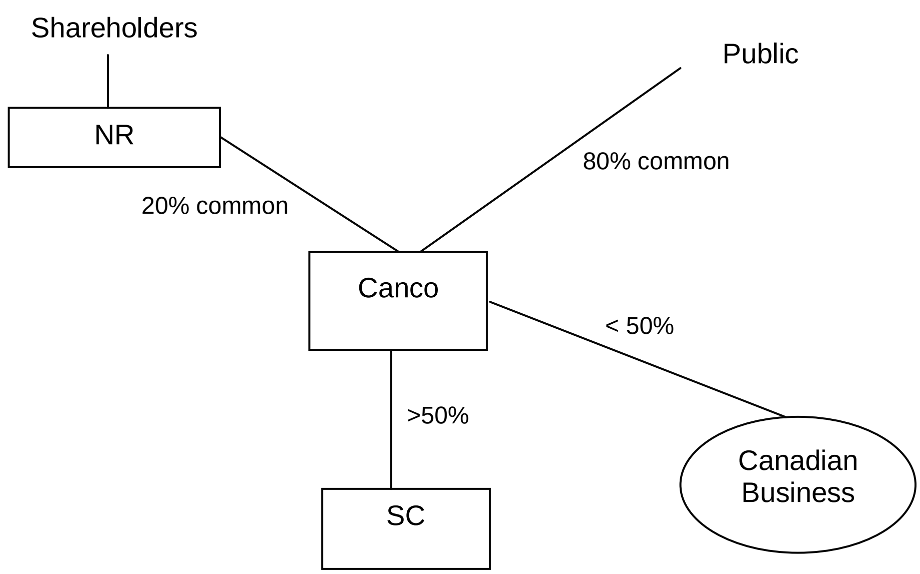
- The $1,000 investment by the CRIC in FA common shares is deemed to be a $1,000 dividend paid by CRIC to NR Parent rather than a $510 dividend representing NR Parent's proportional interest in the CRIC because acquisition of FA shares is seen as an appropriation of CRIC's assets by NR Parent – not by all shareholders.

Appendix B
Going Private Transaction Impeded by Paragraph 212.3(8)(f)

Appendix B

GOING PRIVATE TRANSACTION – EFFECTS OF FA DUMPING RULES ON CONVENTIONAL STRUCTURE

OPENING STRUCTURE



- NR seeking to acquire Public's shares of Canco through take-over bid and subsequent squeeze-out.
- May be hostile or friendly – plan of arrangement may not be feasible.
- Funding through NR's cash on hand and acquisition debt.

A. PREPARATORY STEPS

A.1 NR forms Can Holdco

A.2 Can Holdco forms Bidco

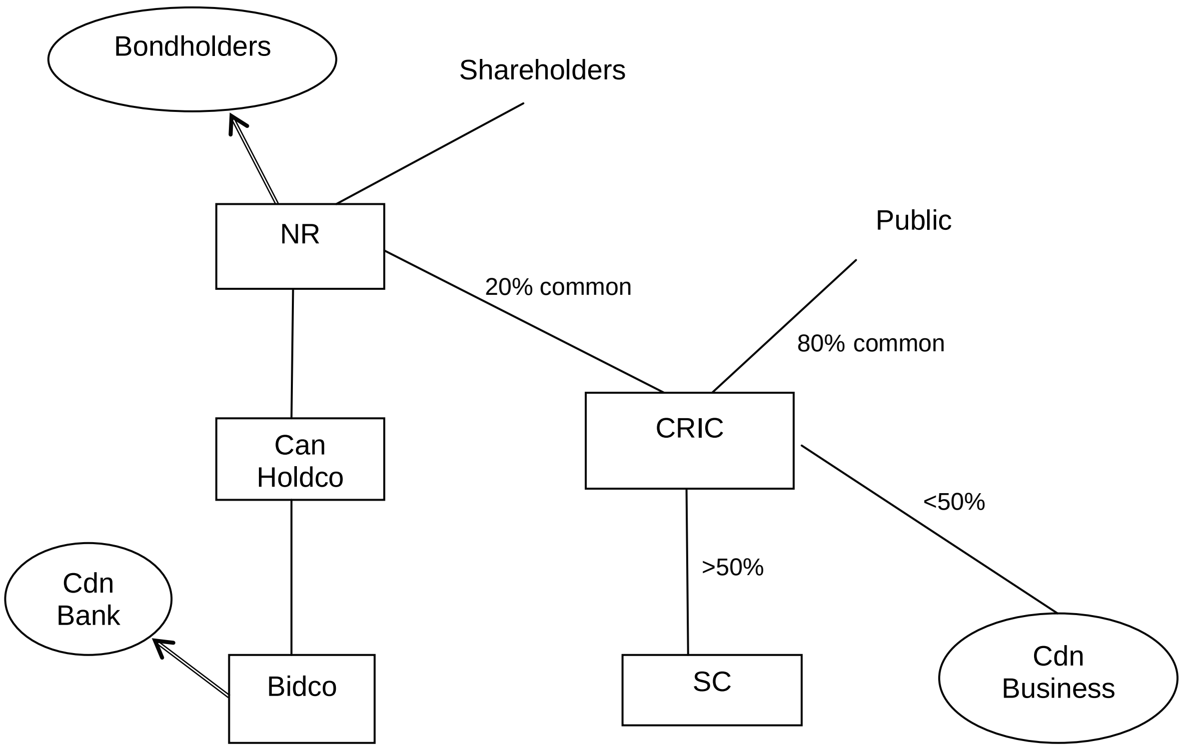
- typical to form both companies in anticipation of squeeze-out and/or bump

A.3 Funding

(i) Bidco borrows from Canadian bank; and

(ii) NR issues shares and debt and uses cash to subscribe for shares of Can Holdco which then subscribes for shares of Bidco.

PRE-BID STRUCTURE

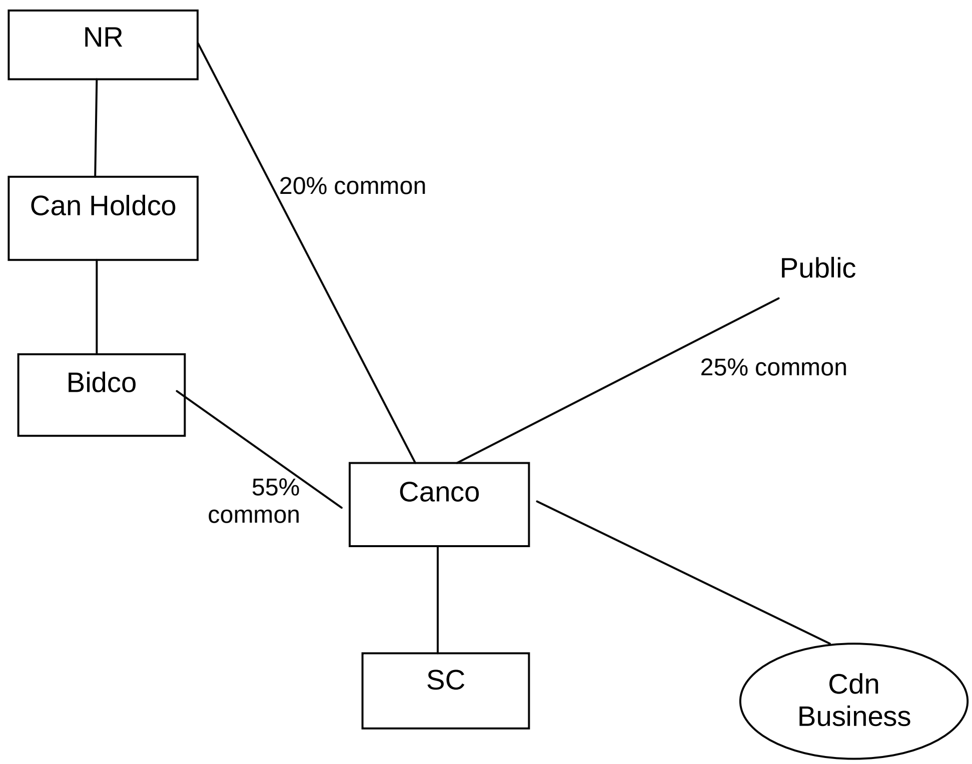


B. **TAKE-OVER BID**

B.1 Bidco offers to buy Canco shares from Public for cash.

B.2 Public tenders 55% of Bidco shares, leaving Public with 25%.

POST-BID STRUCTURE



- Bidco is deemed to pay NR a dividend upon acquisition of Canco shares
  - Withholding tax of 15/25% payable by NR. Why deny 5% rate?
  - Explanatory notes suggest dividend is based on underlying SC value only, though legislation is ambiguous
  - PUC suppression not available because Bidco shares are owned by person not dealing at arm's length with NR (212.3(4)(c))

C. AMALGAMATION SQUEEZE-OUT

C.1 NR uses bond proceeds to subscribe for shares of Can Holdco

C.2 Can Holdco subscribes for Bidco shares for cash (corresponding to 25% minority interest to be redeemed)

- Deemed dividend – this is an acquisition by a CRIC (Can Holdco) of shares of another CRIC (Bidco) with >50% foreign affiliates
- PUC suppression may be available, but this would result in zero cross-border PUC for NR's cash injection, which is inappropriate
- Later PUC reinstatement not available because "acquired shares" are not shares of SC (212.3(7))

C.3 NR transfers Canco shares (legacy 20% interest) to Can Holdco for shares

- Cross-border PUC = 0 (212.3(2)(b)) and no later PUC reinstatement available (since PUC grind was not elective) – despite the fact that 212.1(1)(b) already applies to limit PUC
- 212.3(13)(a) reorganization rule n/a since transferor is NR and transferred shares are not SC shares

C.4 Can Holdco transfers Canco shares (legacy 20% interest) to Bidco for shares

- 212.3(13)(a) reorganization rule n/a since transferred shares are not SC shares
- PUC = 0

C.5 Bidco (which now owns 75% of Canco directly) amalgamates with Canco to form Amalco

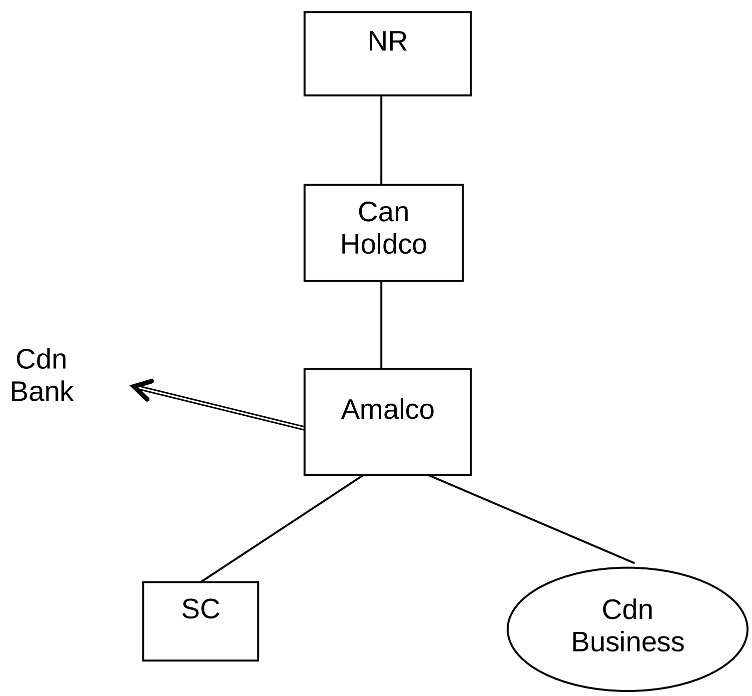
- Canco commons owned by Bidco are cancelled
- Bidco commons owned by Can Holdco are exchanged for Amalco commons → another deemed dividend to NR – 212.3(13)(b) reorg rule n/a since Amalco commons are not SC shares
- Canco commons owned by Public are converted into redeemable prefs with PUC = redemption value
- Amalco acquires SC shares from predecessors – consideration arguably includes debt of predecessors (though there is no allocation rule, so this is unclear) potentially resulting in deemed dividend to NR (15/25%)
    - 212.3(13)(b) reorg rule n/a since Bidco was formerly dealing at arm's length with CRIC – this could potentially be solved by waiting to form the amalgamating company but what tax policy objective does a rule that requires this serve?

    - PUC suppression n/a since CRIC shares not directly owned by NR

  - Significant public shareholders that happen to be CRICs controlled by non-residents make "investment" in preferred shares, resulting in possible deemed dividend

C.6 Redeemable preferred shares are redeemed for cash

FINAL STRUCTURE



Comments

- Double-tiered structure creates problems – rules will distort by forcing single tier initially, and formation of new company after closing → what tax policy objective is served by that?

- Cannot do office incorporation of amalgamating company since that company may arguably have dealt at arm's length with the other companies during the series

- Example shows inappropriate and multiple application of deemed dividend and automatic PUC grind as well as simultaneous application of 212.3 and existing 212.1

- Rules create problem with "bump-and-strip" planning due to lack of PUC reinstatement where PUC grind arose on acquisition of Canco shares (as opposed to SC shares) – this goes well beyond anything in Budget papers.