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

Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association, 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

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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

Mr. Ernewein:

Enclosed is our submission on the amendments that were released by the Department of Finance on July 12, 2013.

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

Francis Favre (KPMG LLP)
Gabe Hayos (CPA Canada)
Angelo Nikolakakis (Couzin Taylor LLP)
Ken Saddington (Goodmans LLP)
Mitch Sherman (Goodmans LLP)
Sandra Slaats (Deloitte & Touche LLP)
Jeff Trossman (Blakes LLP)
Penny Woolford (KPMG LLP)

We trust that you will find our comments helpful and would be pleased to discuss them with you at your convenience.

Yours very truly,

P. Woolford

Penny Woolford
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Mitchell Sherman

Mitch Sherman
Chair, Taxation Section
Canadian Bar Association

The Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada is pleased to provide you with this written submission on certain aspects of the draft legislative proposals released on July 12, 2013 (the "**July Proposals**").

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the *Income Tax Act* (Canada) (the "**Act**") as proposed to be amended under the July Proposals, and all references to any "**Regulations**" are to the *Income Tax Regulations*.

<u>1. Foreign Accrual Tax – Fiscally Transparent Entities</u>

The July Proposals contain a new rule that allows foreign taxes, which are paid by a (foreign affiliate) shareholder of another foreign affiliate that is treated as a fiscally transparent entity ("**FTE**"), to be treated under certain circumstances as foreign accrual tax ("**FAT**"); in such case, the FAT will be eligible for a deduction against foreign accrual property income ("**FAPI**") earned by the FTE. Currently, the Canada Revenue Agency ("**CRA**") allows such taxes to be claimed as FAT, but only if and to the extent that the related income has been distributed to the shareholder as a dividend (to fit within the language of existing subparagraph (a)(ii) of the FAT definition). The new rule provides welcome relief in situations where the earnings of the FTE cannot be currently distributed and thus FAT would not be available under CRA's interpretation. However, we have identified a number of potential improvements to this rule.

a. 5 Shareholder/Member Limitation

Clause (a)(ii)(D) of the proposed definition limits the application of the new rule to situations where neither the particular FTE, nor any intermediary entity between the FTE and the shareholder foreign affiliate, has more than five members or shareholders. The explanatory notes that accompanied the July Proposals (the "**Explanatory Notes**") do not disclose the policy rationale for this limitation. It appears to derive from the original comfort letter promising the amendment, which letter had an even more stringent limitation of three members, but also did not provide any reasons for this limitation. It is notable that the companion rules for surplus adjustments and underlying foreign tax in proposed Regulations 5907(1.091)-(1.092) are not subject to this limitation.

This limitation would deny the FAT relief in many common situations. For example, the particular FTE may be a captive investment fund in which all entities in the group invest (common in the banking and insurance industries). Thus, the FTE can easily have more than five members even though it is wholly owned by the Canadian-controlled group. Alternatively, the Canadian-controlled group may control the particular FTE and there may be a minority interest held by outside investors (common in the real estate and infrastructure industries). In either case, no FAT would be available in respect of any FAPI earned by the particular FTE under the proposed definition. Further, it is unclear whether CRA would still be willing, after this amendment, to apply its historical interpretation to cases where the earnings representing the FAPI have been distributed to the shareholder(s) paying the tax.

We do not see any policy reason why FAT relief should be restricted to closely-held entities (and we note that, even if this were the approach ultimately adopted, there should be a rule allowing related shareholders/members to be aggregated such that only the number of unrelated members would be determinative). In our view, as long as the particular FTE is a controlled foreign affiliate ("**CFA**"), relief should be provided. Otherwise, double taxation could arise.

Recommendation

We recommend that clause (a)(ii)(D) should be deleted in its entirety. This deletion would make the FAT definition consistent with the rules that mandate "appropriate surplus adjustments" in proposed Regulation 5907(1.092). Alternatively, all related shareholders/members should only count as one person for purposes of applying the five member limitation.

b. No Relief where Foreign Tax Paid by Canadian Taxpayer

As proposed, FAT treatment is available for taxes paid by a shareholder of an FTE that is another foreign affiliate of the taxpayer, but not for taxes paid directly by the Canadian taxpayer. Currently, CRA allows a deduction under paragraph 113(1)(c) to be claimed for such taxes, but only if and to the extent that the related earnings have been distributed as dividends. In our view, taxes paid by the Canadian taxpayer in respect of a direct holding in an FTE structure should be eligible for FAT treatment to the same extent as taxes paid by another foreign affiliate in respect of a lower-tier FTE structure. This would be consistent in principle with the rule for "S corporations" in paragraph 5 of Article XXIX of the *Canada-US Income Tax Convention*.

Recommendation

We recommend that subparagraph (a)(ii) be expanded to include situations where it is the Canadian taxpayer that is liable to pay tax in respect of the income of the particular FTE.

2. Stub Period FAPI – Subsections 91(1.1) and 91(1.2)

a. Effective Date

Proposed subsections 91(1.1) and (1.2) are intended to ensure that "stub period" FAPI is included in computing the income of a taxpayer for the taxation year in which the taxpayer disposes of, or reduces, its interest in a foreign affiliate. Assuming that proposed subsections 91(1.1) and (1.2) are enacted into law, they are affective as of July 12, 2013. As a result, if the actual disposition of the shares of a foreign affiliate occurs on or after July 12, 2013, a particular taxpayer may be caught by these rules even if that taxpayer relied on existing law in negotiating and structuring the disposition of its foreign affiliate. For example, it is common to enter into pre-sale restructuring of the disposed group for a variety of non-Canadian tax reasons such as to isolate the entities to be disposed of, remove assets and entities that the purchaser does not wish to acquire, and align the group with the acquirer's acquisition structure. Since based on the long-standing scheme of the Act, no FAPI would arise in respect of the stub period, such reorganizations may have been carried out and may now result in significant FAPI, even where alternative ways of structuring the transaction that would not have resulted in FAPI would have been available. Thus, Canadian taxpayers that in good faith relied on the existing rules may have inadvertently triggered significant amounts of FAPI as a result of business-motivated restructuring.

<u>Recommendation</u>

The current rule is clearly that no FAPI is included in a Canadian taxpayer's income where the participating percentage is nil at the foreign affiliate's year-end and this has been a fundamental component of the foreign affiliate rules since their inception. In light of this history, we believe that it would serve the interest of fairness, predictability and certainty to delay the effective date, such that subsection 91(1.1) applies only to taxation years of foreign affiliates that begin after July 12, 2013. This would properly reflect the fact that before the announcement of the new rules, taxpayers would have relied on the long-standing existing rules to arrange their affairs.

Alternatively, at the very least, subsection 91(1.1) should not apply to FAPI arising from transactions undertaken before July 13, 2013 that fall into a taxation year of a CFA that includes July 12, 2013**.**

b. Triggering Events

As currently drafted, proposed subsection 91(1.1) would apply at any time when a Canadian-resident taxpayer's "surplus entitlement percentage" ("**SEP**") (defined in subsection 95(1) by reference to Regulation 5905(13)) in respect of a CFA of the taxpayer decreases, whether as a result of a disposition by the taxpayer of shares of the foreign affiliate or otherwise. Thus, no transactional triggering event is required. This can give rise to a potentially infinite number of deemed year-ends in circumstances where a CFA has more than one class of shares outstanding and the distribution entitlements on those shares vary over time as a function of the CFA's earnings or other factors, such as where the CFA has common shares and preferred shares and the latter have entitlements that accrue over the year.

In contrast, the various rules in Regulation 5905 take a more transactional approach with respect to when adjustments are required to a foreign affiliate's surplus and other accounts as a result of changes to a taxpayer's relative SEP. We submit that this approach is more practical and consistent with the object of proposed subsection 91(1.1).

Recommendation

Revise proposed subsection 91(1.1) so that it applies only where there has been a decrease in SEP resulting from an event to which any of Regulation 5905(1), 5905(3), 5905(5) or 5905(5.1) is applicable.

c. De-Minimis Exception

As currently drafted, a deemed year-end is triggered whenever there is any change in SEP, no matter how small. This could create significant compliance issues where there are many transactions during the year that affect a CFA's shareholdings. For example, the CFA may be a public company in which the taxpayer has a controlling interest but the taxpayer (or another foreign affiliate of the taxpayer) frequently trades in shares of the CFA (e.g., to maintain its ownership interest at a constant level where the total number of shares changes frequently as a result of the exercise of employee stock options or warrants). Another situation we are aware of involves a CFA with a minority shareholder whose interest ratchets up periodically in small increments to reflect a carried interest. Also, if a taxpayer sells, say, a 20% interest and in the same taxation year buys back a 20% interest, then the initial sale triggers a deemed year-end even though ultimately there is no reduction in the FAPI pick-up measured at the end of the year. In our view, the rules should be targeted to capture only significant dispositions that would materially reduce the amount of FAPI included in the taxpayer's income.

Recommendation

Subsection 91(1) should not apply to any particular decrease in SEP if the cumulative net decrease in the taxpayer's SEP in a particular taxation year is not more than 5%. On the other hand, if the 5% threshold is exceeded, then every transaction resulting in a SEP decrease will trigger a separate deemed year-end. The reference to "net decrease" is intended to allow increases and decreases in the SEP occurring in the same taxation year of a CFA to be netted.

d. Scope of Application

Proposed subsection 91(1.1) recites that it applies "For the purposes of this section", meaning that it applies for the purposes of section 91. It is not clear how this deemed year-end integrates with the various "throughout the year" requirements in other parts of the subdivision, nor that it would apply for surplus computation purposes under the Regulations. This is of particular concern where a taxpayer receives dividends from the affiliate during the stub period and the entity is no longer a foreign affiliate at its regular year-end – in this scenario, it does not appear that any foreign tax paid in respect of FAPI earned in the stub period would entitle the taxpayer to a deduction under paragraph 113(1)(b). Also, there may not be sufficient taxable surplus to claim a deduction under subsection 91(5). Furthermore, it is not clear how the FAT should be apportioned to the multiple tax year-ends that may arise in a single taxation year.

Moreover, the possibility of multiple deemed year-ends arising because of proposed subsection 91(1.1) is problematic with respect to the carry-forward and carry-back limitations in Regulations 5903 and 5903.1.

Another area of concern relates to the interaction between proposed subsection 91(1.1) and the rules in subsection 261(6.1).

Recommendation

Clarify the application of proposed subsection 91(1.1) so that it applies for all purposes of subdivision i, and for the purposes of the Regulations (other than Regulations 5903 and 5903.1), but only to the extent such application is relevant in computing:

(a) The amount of any income inclusion in relation to any CFA of the taxpayer under subsection 91(1) or any deduction under subsection 91(4) or (5);

(b) The amount of any deduction under section 113 in respect of a dividend paid during the stub period; and

(c) The determination of whether paragraph 95(2)(a) applies in respect of any income of any foreign affiliate of the taxpayer, or whether any property of any foreign affiliate of the taxpayer is excluded property, at any time during the stub period.

For this purpose, we would recommend that Regulation 5901(2)(a) should be read without reference to the phrase "that is more than 90 days after the commencement of that year". This is necessary to ensure that any FAPI included during the stub period generates taxable surplus and underlying foreign tax that can be attributed to any dividends paid during the stub period, even if within the first 90 days of the year. This is particularly important where the taxpayer disposes of its entire interest in the CFA and thus no longer has access to surplus pools at the end of the deemed taxation year.

In this respect, there may be a timing issue since the surplus measurement time in Regulation 5901(2)(a) is "immediately after the end of the year" while the deemed year-end in subsection 91(1.1) is immediately before the time of the SEP reduction. Thus, the surplus measurement time would coincide with the time of disposition of the shares. To remedy any resulting uncertainty as to whether the CFA would still be a foreign affiliate at that time, it may be advisable to change the timing of the subsection 91(1.1) deemed year-end to be "immediately before the time that is immediately before the particular time."

To avoid uncertainties regarding the computation of FAT, the rules should set out a specific methodology for computing the tax that should be allocated to the stub period.

e. Proposed Subsection 91(1.2) and Groups of Taxpayers

Proposed subsection 91(1.2) provides that proposed subsection (1.1) would not apply to a taxpayer if another taxpayer resident in Canada that is connected to the taxpayer has an increase in its SEP in respect of the affiliate equal to the reduction in the taxpayer's SEP in respect of the affiliate at the particular time. We submit that this provision is too narrow, because it seems to require that the decrease in the taxpayer's SEP must correspond exactly to an increase in the SEP of a single connected taxpayer. This might not accommodate circumstances in which the decrease in the taxpayer's SEP corresponds to an aggregate increase in the SEP of several connected taxpayers. Moreover, this requirement should be complemented by rules that accommodate amalgamations and the winding-up of the taxpayer.

Furthermore, we submit that the standard of being "connected" by way of ownership of 90% of every class is too narrow, because the CFA's FAPI accrued during the stub period would be attributed to any acquiror in respect of whom the particular taxpayer is a "specified person or partnership", as defined in subsection 95(1), such that paragraph 95(2)(f.1) would not be applicable. In such circumstances, the same FAPI would be taxed twice – once to the vendor under subsection 91(1.1), and again to the purchaser under general rules due to the inapplicability of paragraph 95(2)(f.1).

Recommendation

Revise proposed subsection 91(1.2) so that it overrides the application of subsection (1.1) to the extent that the decrease in the taxpayer's SEP corresponds to an aggregate increase in the SEP of one or more other taxpayers in respect of whom the first-mentioned taxpayer is a "specified person or partnership" as defined in subsection 95(1).

f. Potential Double Counting of FAPI

The subsection 91(1.1) deemed year-end can result in double taxation of the same income as FAPI in circumstances where neither proposed subsection 91(1.2) nor paragraph 95(2)(f.1) applies. For example, consider a 50/50 joint venture between arm's-length Canadian taxpayers: Canco 1 and Canco 2 each own 50% of the shares of a CFA. Halfway through the year, Canco 1 sells its 50% interest to Canco 2. CFA generates $100 of FAPI which accrues evenly over the year. In respect of Canco 1, CFA is deemed to have a year-end under subsection 91(1) and thus Canco 1 will pick up FAPI of $25 ($100 x ½ year x 50% participating percentage). From the perspective of Canco 2, there is no deemed year-end on the acquisition, and thus it will pick up $100 of FAPI at the CFA's regular year-end (based on its 100% participating percentage at year-end). Paragraph 95(2)(f.1) does not apply because the CFA was already a foreign affiliate of Canco 2 prior to the acquisition of the other 50%. Proposed subsection 91(1.2) does not apply because Canco 1 and Canco 2 are not connected. Thus, a total of $125 is taxed as FAPI even though the underlying income is only $100. In our view, this creates an inappropriate result.

Recommendation

One potential solution would be to provide that a taxpayer, that has an increase in its SEP in an existing CFA as a result of a transaction that subjects another taxpayer(s) to a deemed year-end under subsection 91(1.1), has the ability to file an election to trigger a deemed year-end immediately prior to the relevant transaction.

3. Other Inconsistencies in the FAPI Rules

We also recommend that consideration be given to certain additional FAPI issues for which the stub period changes may create further difficulties for taxpayers. Several of these points were raised in a previous Joint Committee submission in the context of recent rule that stream foreign accrual capital losses.

a. Treatment of Capital Gains and Losses

Recent amendments to the FAPI rules now require the separate streaming of foreign accrual capital losses ("**FACL**s"), which can now only be deducted against taxable capital gains included in FAPI. While this change improved the alignment of the FAPI regime with the taxation of the same type of income earned directly, this alignment remains incomplete because FAPI arising from capital gains is treated as income in the hands of the relevant taxpayer, despite that only the "taxable" portion of capital gains is included.

This precludes a taxpayer from offsetting available capital losses from other sources against capital gains that are attributed to the taxpayer under the FAPI regime. Moreover, this can result in inappropriate taxation from a single source where FAPI is attributed to the taxpayer in respect of a capital gain realized by a CFA and then the taxpayer realizes a capital loss from the disposition of the shares of the very same CFA. In the private corporation context, an additional concern arises because the FAPI inclusion is not added to the corporation's "capital dividend account" ("**CDA**"), thereby undermining the "integration" of corporate and personal income taxes.

Recommendation

We submit that it would be feasible and appropriate to divide the current definition of FAPI in subsection 95(1) into two definitions, one for income and one for capital gains. Essentially, that would involve the removal of the descriptions of B and E (and F.1) from the current definition of FAPI in subsection 95(1), to be included in a new definition applicable only to capital items, and possibly some restructuring of those parts of the current definition of FAPI in subsection 95(1) that relate to debt forgiveness. In addition, this approach would require the introduction of a new deemed taxable capital gains rule, which might be worded as follows:

> **91. (1.3) Deemed Taxable Capital Gains —** In computing the taxable capital gains from the disposition of a property for a taxation year of a taxpayer resident in Canada, there shall be included, in respect of each share owned by the taxpayer of the capital stock of a controlled foreign affiliate of the taxpayer, the percentage of the foreign accrual taxable capital gains of any controlled foreign affiliate of the taxpayer, for each taxation year of the affiliate ending in the taxation year of the taxpayer, equal to that share's participating percentage in respect of the affiliate, determined at the end of each such taxation year of the affiliate.

Moreover, to bridge this rule with section 3 (and other relevant provisions), paragraph 38(a) could be reworded to add reference to the new deemed taxable capital gains rule, and a new paragraph could be added to section 38, as follows:

> **(a) [Taxable capital gain] —** subject to paragraphs (a.1) to (a.4), a taxpayer's taxable capital gain for a taxation year from the disposition of any property is 1/2 of the taxpayer's capital gain for the year from the disposition of the property;
>
> […]
>
> **(a.4) Foreign Accrual Taxable Capital Gains —** each amount that is required to be included in computing a taxpayer's taxable capital gains from the disposition of a property for a taxation year of the taxpayer pursuant to subsection 91(1.3) shall be deemed to be a taxable capital gain of the taxpayer for the taxation year from the disposition of a property other than listed personal property;

Finally, to bridge this rule with the CDA regime, a new paragraph could be added to that definition in subsection 89(1), as follows:

> (h) all amounts each of which is an amount that is required to be included in computing a taxpayer's taxable capital gains from the disposition of a property for a taxation year of the taxpayer pursuant to subsection 91(1.3),

We submit that this approach would render the FAPI regime more consistent with the overall scheme, thereby improving the fairness and integrity of the regime.

4. Foreign Mergers - New Subsection 87(8.3)

Proposed subsection 87(8.3) is an anti-avoidance rule that is meant to prevent the circumvention of subsection 85.1(4). Subsection 85.1(4) denies the subsection 85.1(3) foreign affiliate rollover in circumstances where a taxpayer uses the rollover to indirectly transfer shares of a foreign affiliate (all or substantially all of the property of which is "excluded property") to an arm's-length purchaser in order to avoid Canadian tax on the disposition. Subsection 87(8.3) is intended to prevent taxpayers from using a tax-deferred subsection 87(8) foreign merger to achieve the same result.

The conditions for the application of subsection 85.1(4) are similar to those for proposed subsection 87(8.3). However, subsection 85.1(4) does not apply where the arm's-length purchaser is a foreign affiliate of the taxpayer in which the taxpayer has a "qualifying interest" within the meaning of paragraph 95(2)(m). Proposed subsection 87(8.3) does not include such a carve-out. In addition, subsection 85.1(4) applies to a disposition of foreign affiliate shares to an arm's-length partnership. Subsection 87(8.3) applies to a disposition of shares of the new foreign corporation to a partnership, any member of which deals at arm's-length with the taxpayer. The level of ownership of that member(s) could be immaterial.

Having regard to the stated purpose of this provision, we do not see any policy reason why subsection 87(8.3) should have broader application than subsection 85.1(4).

Recommendation

We recommend that the conditions for the application of subsection 87(8.3) be amended to be consistent with subsection 85.1(4). Specifically, we recommend that paragraph 87(8.3)(c) include a carve-out for dispositions to an arm's-length corporation that is a foreign affiliate of the taxpayer in which the taxpayer has a "qualifying interest". We also recommend that subparagraph 87(8.3)(c)(ii) be amended to apply to a disposition of shares of the new foreign corporation to an arm's-length partnership.

5. Functional Currency Election - Subsections 261(6) and (6.1)

Amended subsection 261(3) requires a functional currency election to be filed with the Minister within 60 days from the beginning of the taxation year for which a taxpayer wishes to compute its tax results in its elected functional currency. Prior to this amendment, the election was required to be filed at least six months before the end of the year. This change is welcome and fixes many problems that previously existed with the timing of the election, particularly where taxpayers have shortened tax years.

Subsection 261(6) applies where a functional currency taxpayer is or becomes a member of a partnership, and subsection 261(6.1) applies where a functional currency taxpayer has one or more foreign affiliates. In effect, these provisions attribute the functional currency of the taxpayer to the partnership or foreign affiliate, as the case may be, for the purpose of computing the taxpayer's partnership allocation or FAPI. More specifically, the rules apply as if the partnership or foreign affiliate were a taxpayer that had made a similar functional currency election. As a result of the July Proposals, however, the timing of the first functional currency date of the partnership and foreign affiliate seems to have changed. Amended subparagraph 261(6)(a)(iii) and clause 261(6.1)(a)(i)(C) cause the functional currency rules to apply to the partnership or foreign affiliate in its first fiscal period or taxation year that starts on or after the day that is 60 days after the first day of the electing taxpayer's first functional currency year.

We understand that one of the purposes of the election timing requirements is to limit the extent to which a functional currency election has retroactive effect. The amended rule permits a 60-day period in which to file an election. However, for partnerships and foreign affiliates, the amended rule permits no retroactive period, and in fact seems to require a lag in the change to a functional currency. Furthermore, assuming that subsections (6) and (6.1) are intended to apply iteratively, a tiered structure with both foreign affiliates and partnerships could be subject to a multi-year lag, even where all taxation years and fiscal periods end coincidentally. It is common in corporate groups to seek to harmonize all of the taxation year and fiscal period ends. Where the taxation year of a foreign affiliate and fiscal period of a partnership are the same as that of a taxpayer, we believe the change to a functional currency should occur at the same time.

Recommendation

We recommend that the rules should be amended so that foreign affiliates and partnerships are treated as if their first functional currency year were the taxation year or fiscal period, as the case may be, that begins on or after the *first* day of the electing taxpayer's first functional currency year.

6. Taxable Canadian Property

a. Listed Shares Owned through Partnerships

The July Proposals amend the definition of taxable Canadian property ("**TCP**") in subsection 248(1). In particular, it is proposed that the ownership threshold for listed shares and mutual fund units or shares[1] (found in paragraph (e) of the definition) be changed where shares are owned through a partnership.

Under current law, listed shares will not constitute TCP to a taxpayer unless the taxpayer meets the 25% ownership threshold specified in paragraph (e) (and, although not relevant to the present issue, more than 50% of the share value is attributable to Canadian real estate or resource property). In determining whether the share ownership threshold is met, the taxpayer must count any shares owned by the taxpayer itself, as well as shares owned by persons with whom the taxpayer did not deal at arm's length, during the 60-month testing period. This test effectively limits the ambit of the definition to situations where the taxpayer group effectively has a 25% or greater economic interest in the corporation, or at least in a particular class of shares of the corporation. While shares owned by non-arm's length persons are effectively imputed to the taxpayer, there is generally no imputation of shares owned by lower-tier entities in which the

[1] For ease of reference, we will refer to "shares" in the text of this submission; however, it should be understood that our comments apply equally to listed shares, shares of mutual fund corporations, and units of mutual fund trusts.

taxpayer has a non-controlling interest. This limitation is sensible, because a taxpayer will typically lack the ability to ascertain with any degree of certainty the investments made by entities in which the taxpayer has only a portfolio investment.

We are concerned that the amendment in the July Proposals goes well beyond the mischief at which we suspect it was aimed, and is inconsistent with the existing tax policy that requires a taxpayer group to have a significant economic interest in a public entity before TCP status is obtained.

We are aware that CRA recently released a technical memorandum concerning the application of the 25% threshold where shares are held by a non-resident taxpayer through a partnership.[2] In the memorandum, the CRA Rulings Directorate responded to a question concerning a situation where listed shares were held by a non-resident taxpayer through a partnership. CRA noted that the "hypothetical taxpayer" rules in subsection 96(1) do not apply for purposes of paragraph 2(3)(c), which is the basic charging provision under which TCP gains realized by a non-resident are taxable. Therefore, the 25% threshold in paragraph (e) of the TCP definition would not be applied at the partnership level, but rather at the level of the partner.

CRA went on to assert that "under common law a member of a partnership may not own any property of the partnership in species (sic) *but only jointly with the other members of the partnership*". Thus, "it may not be said that the non-resident partner owned a specific percentage of the underlying property of the partnership". It would seem to follow from this conclusion that even where a taxpayer owns *more than 25%* of a class of listed shares, if those shares are owned *through a partnership*, then the shares would never be TCP. Recognizing the possible anomaly, CRA stated that it believed this result to be unintended and that it had advised the Department of Finance. CRA also stated that GAAR may apply where a taxpayer interposes a partnership to escape TCP treatment.

We accept the conventionally held position that the nature of a partner's interest in partnership property is subject to significant uncertainty as a matter of commercial law. Notwithstanding this, it is submitted that the appropriate legislative response to "plug" the apparent "loophole" would be to change the ownership attribution rule so that shares owned by a taxpayer indirectly, through one or more partnerships, are deemed to be owned by the taxpayer on a fair market value apportionment basis. This would eliminate the possible anomaly identified by CRA, whereby a taxpayer which has a 25% (or greater) interest in listed shares could escape TCP treatment by interposing a partnership.

However, the proposed amendment appears to have a much broader scope. In particular, it is proposed that, in determining whether the ownership threshold is met by a particular taxpayer, the taxpayer would effectively be treated as if it owned <u>all</u> shares owned by any partnership in which the taxpayer (or a person not dealing at arm's-length with the taxpayer) has a direct or

[2] CRA Document 2010-038593117, dated March 19, 2013.

indirect interest, through one or more partnerships. There is no *de minimus* rule. The taxpayer (or a non-arm's-length person) could own only a very small interest (say 0.01%) in a partnership, and this could be through one or more intermediate partnerships; yet 100% of the shares owned by that partnership in the Canadian corporation will be treated as if they were owned by the taxpayer.

This proposed change has the effect of dramatically (and we would suspect unintentionally) expanding the TCP definition in some fact patterns. One immediate problem is that taxpayers may have no reliable means to monitor such an onerous aggregation principle; for example, fund of funds investments are commonplace, and one cannot reasonably expect a small investor in an upper-tier fund to constantly monitor all investments in a lower-tier fund over a rolling 60-month period. Furthermore, a taxpayer may not even become a member of the partnership until sometime after the partnership held shares. A look-through rule could assist with this issue, if it only attributes shares owned by the partnership while a member.

The Explanatory Notes assert that the amendment is intended to "ensure that a disposition by a partnership of taxable Canadian property constitutes a disposition of taxable Canadian property by a non-resident partner". This statement sounds reasonable in principle, but its meaning is not entirely clear. It could suggest that (i) TCP status should be determined at the partnership level (as if the partnership were a subsection 96(1) taxpayer for this purpose) and then attributed to its partners; (ii) TCP status should be determined on a proportionate look-thorough basis to the partners; and/or (iii) more simply, a partnership should not be used as a device to avoid TCP status that would otherwise arise through direct ownership. Unfortunately, the amendments seem to go well beyond any of this. The taxpayer might have a 0.01% interest in a partnership that owns 15% of the issued shares of a public company and may separately own (itself or via non-arm's-length persons) another 10%. In such a case, the taxpayer (and everyone else in its group) would be required to treat the listed shares as TCP. It seems to us that this represents a significant (and unwarranted) change.

In our view, the change in the July Proposals is overly broad. A non-resident who has an interest in a partnership (any partnership, wherever formed) which happens to own (directly or indirectly through lower-tier partnerships) listed shares of a Canadian real estate or resource company may now become taxable on gains realized at the partnership level despite the fact the taxpayer is a true portfolio investor whose total interest on a look-through basis may be very small. We believe that this outcome is inconsistent with the policy of the TCP provision, and with other positions taken by CRA that are intended not to prejudice investors for having invested in Canada through a partnership fund (for example, the position taken in respect of the application of Article XXI of the Canada-U.S. Income Tax Convention). Once understood, the effect of this provision may be to inhibit some funds structured as partnerships from investing in Canadian resource or real-property-rich companies for fear they may create unexpected tax liabilities for foreign portfolio investors on exit.

Recommendation

We believe it would be more appropriate to treat non-resident taxpayers as if they owned their proportionate share (rather than 100%) of listed shares owned through partnerships. This would eliminate the anomaly identified by CRA, and would reinforce the basic tax policy rule reflected in the existing TCP definition whereby only taxpayers having a significant interest in a corporation must treat listed shares as TCP.

b. Timing of Application

The proposed amendment applies in determining on or after July 12, 2013 whether shares are TCP. This phase-in rule has a significant retroactive effect. Taxpayers owning listed shares through partnerships would become taxable (at the time of disposition) on gains accrued prior to July 12, 2013, and, therefore, at a time when such shares were clearly not TCP.

Recommendation

If the proposed amendment is enacted (and as noted above, we believe it should be significantly modified), the phase-in rule should be changed so that only the gain accruing after July 12, 2013 would be taxable in circumstances where the shares were not TCP immediately before July 12, 2013. This would be the only fair application of this new rule, because the significant expansion of the TCP definition could not reasonably have been anticipated by taxpayers.

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