Comité mixte sur la fiscalité de
l'Association du Barreau canadien

et de

Comptables professionnels agréés du Canada
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Monsieur,

Objet : Propositions législatives publiées en août 2022 relatives à la *Loi de l'impôt sur le revenu* et au *Règlement de l'impôt sur le revenu* (modifications techniques)

Veuillez trouver ci-joint un mémoire exposant le point de vue du Comité mixte sur la fiscalité de l'Association du Barreau canadien et de Comptables professionnels agréés du Canada (le « Comité mixte ») concernant les points suivants des propositions législatives relatives à la *Loi de l'impôt sur le revenu* et au *Règlement de l'impôt sur le revenu* (modifications techniques) :

- Points 12 (échanges d'actions de sociétés étrangères affiliées) et 13 (fusions)
- Point 19 (revenu étranger accumulé, tiré de biens)

Les membres du Comité mixte seront heureux de discuter de ces questions plus en détail si cela peut être utile.

Nous vous prions d'agréer, Monsieur, nos salutations distinguées.

David Bunn	Ian Crosbie
Président, Comité sur la fiscalité	Président, Section du droit fiscal
Comptables professionnels agréés du Canada	Association du Barreau canadien

Submission of the Joint Committee on Taxation of The Canadian Bar Association and Chartered Professional Accountants of Canada
August 2022 Legislative proposals relating to the Income Tax Act and the Income Tax Regulations (Technical Amendments)
Clause 12 (Foreign affiliate share-for-share exchanges) and Clause 13 (Amalgamations)

Please find below our comments on the proposed amendments to subsections 85.1(4) and 87(8.3).

Subsection 85.1(4)

Subsection 85.1(4) outlines the circumstances in which the rollover treatment that would otherwise be available under subsection 85.1(3) is denied. As a preliminary comment, while we recognize that there are policy concerns which the proposed amendments seek to address, we also believe that the current version of subsection 85.1(4) has generally been viewed as an adequate safeguard, and as such we recommend that the proposed amendments be considered with this in mind.

Purpose test

The existing language in subsection 85.1(4) includes a purpose test – i.e., the initial transfer must be part of a series of transactions for the purpose of selling the shares of the first affiliate to a relevant subsequent acquiror. The proposed amendments to subsection 85.1(4) eliminate the purpose test and simply require the initial transfer to be part of a series of transactions that includes another disposition of the shares of the first affiliate (or certain other properties). Given that a "series of transactions" can be extremely broad and open to varying interpretations, we believe the elimination of the purpose test could result in significant uncertainty for both taxpayers (who must comply with the rule) and the CRA (who must administer the rule).

Recommendation: The purpose test under existing law should be retained.

Relevant subsequent acquirors

The proposed amendments to subsection 85.1(4) contemplate a change to the scope of relevant subsequent acquirers. Currently, access to rollover treatment is only denied where the subsequent acquirer is an arm's length person, other than a foreign affiliate of the taxpayer in which the taxpayer has a qualifying interest (a 10% votes and value test). Under the proposed amendments, access to rollover treatment is denied where the subsequent acquiror is either an arm's length person or a non-arm's length non-resident person, other than a controlled foreign affiliate of the taxpayer for the purposes of section 17 (a voting control test which requires the affiliate to be controlled by the taxpayer and other non-arm's length Canadian residents). We understand that expanding the scope of relevant subsequent acquirors to include non-arm's length non-residents is to address a concern that subsection 85.1(3) could be used to move a directly held foreign affiliate out-from-under Canada on a tax-deferred basis. Similarly, we understand that narrowing the carve out for foreign affiliate subsequent acquirors to only include controlled foreign affiliates (as defined in section 17) is intended to limit the opportunity for tax-deferred out-from-under transactions. However, while the intention is to limit the opportunity for tax-deferred out-from-under transactions, we believe that moving from a votes and value test (i.e., qualifying interest) to a voting control test (i.e., CFA status) could potentially facilitate the types of transactions that the proposed amendments are intended to prevent.

Recommendation: The carve out for foreign affiliate subsequent acquirors should continue to refer to a foreign affiliate of a taxpayer in which the taxpayer has a qualifying interest (i.e., a 10% votes and value test) rather than referring to a controlled foreign affiliate of the taxpayer within the meaning of section 17 (i.e., a voting control test).

<u>Relevant subsequent dispositions</u>

The proposed amendments contemplate a significant expansion to the scope of subsequent transactions that are considered to be relevant subsequent dispositions. In particular, it would no longer be limited to the disposition of shares of the first affiliate, but would instead encompass a disposition of any property that is substituted for the shares the first affiliate, as well as any other property any of the fair market value of which is derived, directly or indirectly, from the shares of the first affiliate. We understand that the purpose of this change is to prevent taxpayers from avoiding subsection 85.1(4) by structuring the subsequent disposition as an indirect disposition of the shares of the first affiliate. However, we are concerned that the manner in which the "indirect disposition" concept has been drafted is extremely broad. For instance, it seems that the transfer of a first affiliate from a Canadian corporation to a second affiliate followed by an outright sale of the second affiliate by the Canadian corporation is caught by the proposed amendments, even though the subsequent disposition in this case is taxable in Canada without any opportunity for deferral. Similarly, it appears that the transfer of a first affiliate from a Canadian corporation to a second affiliate followed by an outright sale of the Canadian corporation by its shareholder(s) is caught, as the fair market value of the shares of the Canadian corporation is derived, in part, from the underlying shares of the first affiliate. Also, since there is no proportionality concept included in the rules, it appears that if a single share of an upper-tier affiliate is disposed of, it would taint the rollover as whole as that single share would derive a portion of its fair market value from each underlying share of the first affiliate.

Recommendation: The scope of relevant subsequent dispositions should be limited to subsequent dispositions <u>by a foreign affiliate</u> of the taxpayer of (i) shares of the first affiliate, (ii) property substituted for shares of the first affiliate, or (iii) <u>shares of another foreign affiliate</u> of the taxpayer that derive any of their fair market value from property referred to in (i) or (ii). For greater certainty, the scope of relevant dispositions should not include a disposition of foreign affiliate shares by the Canadian taxpayer (regardless of whether such shares derive a portion of their value from the shares of the first affiliate) nor a disposition of the shares of the Canadian taxpayer or the shares of any corporation higher up the ownership chain. Further, a proportionality concept should be introduced such that a disposition of shares of another foreign affiliate that derive any of their fair market value from the shares of the first affiliate (or substituted property) only leads to a denial of rollover treatment in proportion to the subsequent disposition.

<u>Excluded property status</u>

Under existing law, excluded property status is tested by considering whether all or substantially all of the property of the first affiliate is excluded property at the time of the initial transfer. The proposed amendments contemplate that excluded property status be tested twice: (i) at the time of the initial transfer, by considering whether all or substantially all of the property of the first affiliate is excluded property at that time, and (ii) at the time of the relevant subsequent disposition, by considering whether the property disposed of is excluded property at that time. We understand that the second test was included in the proposed amendments to address a concern that a first affiliate with property that includes non-excluded property could be transferred to a second affiliate, purified, and then sold to a subsequent acquiror at a time when the shares of the first affiliate qualify as excluded property. We agree with this approach. However, by retaining the initial test along with the new test, there could be scenarios where all or substantially all of the property of the first affiliate is excluded property at the time of the initial transfer, but the property disposed of on the subsequent disposition is not excluded property at the time of the subsequent disposition. In a scenario like this, the initial transfer would be denied rollover treatment even though the subsequent disposition would give rise to FAPI. Given that the relevant test for deferral is whether the property that is disposed of on the subsequent disposition is excluded property at the time of the subsequent disposition, we believe the first test should be eliminated, and that only the second test should remain.

Recommendation: The excluded property test should be applied with reference to the excluded property status of the property that is disposed of on the subsequent disposition. The additional (existing) requirement to test the excluded property status of the property of the first affiliate at the time of the initial transfer should be eliminated.

Subsection 87(8.3)

Similar concerns exist for the proposed amendments to subsection 87(8.3), which outlines the circumstances in which the rollover treatment under subsection 87(8) is denied.

Relevant subsequent acquirors

Similar to the above discussion, the proposed amendments to subsection 87(8.3) contemplate a change to the scope of relevant subsequent acquirers. This includes a change to the carve out for foreign affiliate subsequent acquirors. In particular, rather than having a carve out for foreign affiliates of the taxpayer in which the taxpayer has a qualifying interest there would instead be a carve out for controlled foreign affiliates of the taxpayer for the purposes of section 17. As noted above, we believe that moving from a votes and value test (i.e., qualifying interest) to a voting control test (i.e., CFA status) could potentially facilitate the types of out-from-under transactions that the proposed amendments are intended to prevent.

Recommendation: The carve out for foreign affiliate subsequent acquirors should continue to refer to a foreign affiliate of a taxpayer in which the taxpayer has a qualifying interest (i.e., a 10% votes and value test) rather than referring to a controlled foreign affiliate of the taxpayer for the purposes of section 17 (i.e., a voting control test).

Relevant subsequent dispositions

Similar to the discussion above, the proposed amendments to subsection 87(8.3) contemplate a significant expansion to the scope of subsequent transactions that are considered to be relevant subsequent dispositions – in particular to include not only shares of the new foreign corporation but also substituted property as well as any other property any of the fair market value of which is derived, directly or indirectly, from the shares of the new foreign corporation (or substituted property). Consistent with the discussion above, the concern is that the reference to "property any of the fair market value of which is derived, directly or indirectly, from [the shares of the new foreign corporation or substituted property]" is far too broad.

Recommendation: The scope of relevant subsequent dispositions should be limited to subsequent dispositions <u>by a foreign affiliate</u> of the taxpayer of (i) shares of the capital stock of the new foreign corporation, (ii) property substituted for shares of the new foreign corporation, or (iii) <u>shares of another foreign affiliate</u> of the taxpayer that derive any of their fair market value from property referred to in (i) or (ii). For greater certainty, the scope of relevant dispositions should not include a disposition of foreign affiliate shares by the Canadian taxpayer (regardless of whether such shares derive a portion of their value from the shares of the new foreign corporation) nor a disposition of the shares of the Canadian taxpayer or the shares of any corporation higher up the ownership chain. Further, a proportionality concept should be introduced such that a disposition of shares of another foreign affiliate that derive any of their fair market value from the shares of the new foreign corporation (or substituted property) only leads to a denial of rollover treatment in proportion to the subsequent disposition.

<u>Excluded property status</u>

Similar to the discussion above, the proposed amendments to subsection 87(8.3) contemplate that excluded property status be tested twice: (i) immediately before the merger, by considering whether all or substantially all of the property of the predecessor foreign corporation was excluded property at that time, and (ii) at the time of the subsequent disposition, by considering whether the property disposed of on the subsequent disposition is excluded property at that time. Given that the relevant test for deferral is whether the property that is disposed of on the subsequent disposition is excluded property at the time of the subsequent disposition, we believe the first test should be eliminated, and that only the second test should remain.

Recommendation: The excluded property test should be applied with reference to the excluded property status of the property that is disposed of on the subsequent disposition. The additional (existing) requirement to test the excluded property status of the property of the predecessor corporation immediately before the merger should be eliminated.

Submission of the Joint Committee on Taxation of The Canadian Bar Association and Chartered Professional Accountants of Canada
August 2022 Legislative proposals relating to the Income Tax Act and the Income Tax Regulations (Technical Amendments)
Clause 19 (Foreign Accrual Property Income)

Please find below our comments on the proposed amendments to subsection 95(2).

<u>Clause 95(2)(b)(i)(B)</u>

Clause 95(2)(b)(i)(B) addresses the situation where services fees earned by a particular FA of a taxpayer (the "payee affiliate") that would otherwise be active business income of the payee affiliate are deductible in computing the FAPI of another foreign corporation (the "payer affiliate") and the payer affiliate is (i) a FA of any taxpayer of whom the payee affiliate is a FA or (ii) a FA of another taxpayer who does not deal at arm's length with the payee affiliate or any taxpayer of whom the payee affiliate is a FA. The purpose of clause 95(2)(b)(i)(B) is to ensure that income that would otherwise be FAPI of the payer affiliate cannot be converted into active business income of the payee affiliate through a services arrangement.

Under existing legislation, a disproportionate amount of FAPI can arise where the participating percentage in the payee affiliate is higher than the participating percentage in the payer affiliate. The proposed amendments are intended to address this inequity by limiting the FAPI inclusion in the payee affiliate to a proportional amount when taking into account the participating percentage in the payer affiliate. In particular, the proposed amendments limit the FAPI inclusion for the payee affiliate to the amount determined under the formula A x B, where A is the amount that is deductible in computing the payer affiliate's FAPI, and B is the aggregate participating percentage in the payer affiliate of any taxpayer of which the payer affiliate is a FA.

While this is a welcome amendment and will address the proportionality issue in many cases, it appears that inequitable results can continue to arise when partnerships are involved.

For instance, assume that a Canadian corporation (Canco) owns 100% of a foreign affiliate (FA1). Canco also has a 60% controlling interest in a partnership (P1) that owns 100% of a foreign corporation (FA2) that carries on an investment business. The remaining 40% non-controlling interest in P1 is owned by arm's length non-resident persons. FA1 provides services to FA2 in exchange for a services fee which is deductible in computing the income from the investment business carried on by FA2.

In this case, it appears that the entire services fee earned by FA1 would be included in computing the FAPI of FA1 notwithstanding that only 60% of the services fee is reducing an amount would otherwise to be included in computing the income of a Canadian taxpayer (i.e., since only 60% of the FAPI earned by FA2 is allocated to Canco through P1, with the remaining 40% being allocated to arm's length non-resident partners). In particular, P1 is deemed to be a person resident in Canada for purposes of computing its income under subsection 96(1), and FA2 is a FA of P1 for income computation purposes. Further, P1 is considered to have a 100% participating percentage in FA2 for the income computation purposes. On this basis, it appears that the aggregate participating percentage in FA2 for purposes of clause 95(2)(b)(i)(B) would be 100%.

From a policy standpoint, we believe the amount of the services fee that is included under clause 95(2)(b)(i)(B) in this scenario should be limited to 60%.

Recommendation: The proposed amendments to clause 95(2)(b)(i)(B) should be modified to address the situation where the "payer affiliate" is a FA of a partnership. This could be done, for instance, by including a look-through concept for purposes of clause 95(2)(b)(i)(B) that deems any shares owned by a partnership to be owned by the partners on a *pro rata* basis when applying the aggregate participating percentage concept (i.e., similar to the existing look-through concept in section 93.1). Alternatively, the participating percentage of any shares held by a partnership could be adjusted by the ratio of A/B with "A" being the share of the income of the partnership for the year that is included (directly or indirectly via other partnerships) in computing the income of (i) a taxpayer resident in Canada or (ii) a foreign affiliate of a taxpayer resident in Canada (to the extent of the taxpayer's participating percentage in the foreign affiliate), and "B" being the total income of the partnership for the year. In either case, items (I) and (II) of variable A of the formula would be updated to refer to "any taxpayer <u>(other than a partnership)</u> of whom the affiliate is a foreign affiliate" and "another taxpayer <u>(other than a partnership)</u> who does not deal at arm's length with…".

<u>Subsection 95(3.03)</u>

Proposed subsection 95(3.03) is a new provision that is intended to address the situation where inter-affiliate services fees are paid by a FA Holdco rather than being paid by the underlying FA Opco(s). Subsection 95(3.03) are modelled on existing clause 95(2)(a)(ii)(D) which provides similar relief when inter-affiliate interest is paid by a FA Holdco rather than being paid by the underlying FA Opco(s).

While this is a welcome addition and will address many common scenarios, some areas of concern have been identified. In particular:

1. The various ancillary rules that apply for the purposes of paragraph 95(2)(a) should be extended to proposed subsection 95(3.03) to ensure that it operates properly including, *inter alia*, the "throughout the year" requirement (subsections 95(2.2) and (2.01)), qualifying interest status (paragraph 95(2)(n)), and deeming rules for intervening partnerships (paragraph 95(2)(y) and subsections 93.1(5) and (6)). Without these ancillary rules, there will be situations where relief is not available under subsection 95(3.03), resulting in FAPI where none should exist from a policy standpoint.

2. Paragraph (c) of proposed subsection 95(3.03) requires the services fees to be paid or payable "by the second affiliate". This is problematic since services fees that are paid or payable by a holding partnership in which a FA is a member can be subject to paragraph 95(2)(b) (i.e., if they are deductible in computing the FAPI of the FA member), but cannot qualify under proposed subsection 95(3.03). In the context of clause 95(2)(a)(ii)(D), subsection 93.1(4) was introduced to address such circumstances. We suggest that a similar concept be introduced that provides similar relief for holding partnerships in the context of subsection 95(3.03). However, we note that the requirement in subsection 93.1(4) that all members of the partnership be foreign affiliates should not be extended to paragraph 95(2)(b), given that the latter only applies to the extent that the amounts are deductible by a foreign affiliate.

3. Consideration should also be given to extending subsection 95(3.03) to situations where services fees are incurred by a FA Holdco that has invested in an underlying partnership that holds excluded property shares. While we recognize that this scenario is also problematic under clause 95(2)(a)(ii)(D), we do not believe that this deficiency should be carried over to subsection 95(3.03). Rather, we believe that subsection 95(3.03) should contemplate investments in partnerships that hold excluded property shares (and that similar relief should be provided for clause 95(2)(a)(ii)(D) in due course). This can be accomplished through a specific rule, or by deeming a partnership to be a corporation for the purposes of proposed paragraph 95(3.03)(d).

4. Similarly, while the "subject to tax" requirement in subsection 95(3.03) is modelled on the requirements of existing clause 95(2)(a)(ii)(D), we do not see any policy reason for such a requirement. In many (but not all) cases the payer affiliate will be resident in a country that imposes tax, but the same may not be true with respect to the excluded property shares held by the payer affiliate. For instance, due to commercial or foreign tax reasons, it may be desirable for the payer affiliate to own shares of a foreign holding company (FA Holdco) which owns shares of an underlying foreign operating company (FA Opco) rather owning shares of FA Opco directly. We do not see any policy rationale to base the application of subsection 95(3.03) on whether the payer affiliate and its directly held subsidiaries are subject to tax. As such, we suggest that the "subject to tax" requirement be removed from proposed subsection 95(3.03) (and that the "subject to tax" requirement also be removed from clause 95(2)(a)(ii)(D) in due course).

Recommendations: We recommend that the various ancillary rules that apply for purposes of paragraph 95(2)(a) be extended to proposed subsection 95(3.03), including subsections 95(2.2) and (2.01), paragraphs 95(2)(n) and (y), and subsections 93.1(4), (5) and (6) (with appropriate modifications). We also recommend that proposed subsection 95(3.03) be extended to situations where services fees are incurred by a payer affiliate for the purpose of earning income from a partnership that holds excluded property shares, and that the "subject to tax requirement" in proposed subsection 95(3.03) be eliminated.