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

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May 24, 2019

Ted Cook
Director General
Tax Legislation Division
Tax Policy Branch, Department of Finance
90 Elgin Street, Ottawa, ON K1A 0G5

Dear Mr. Cook:

Subject: Foreign Affiliate Dumping, Derivative Forward Agreement and Transfer Pricing Amendments Announced in the 2019 Federal Budget

We have enclosed submissions dealing with the amendments to the foreign affiliate dumping rules and the derivative forward agreement rules and the introduction of transfer pricing ordering rules that were included in the 2019 federal budget.

Members of the Joint Committee and others in the tax community participated in the discussion concerning this submission and contributed to its preparation, including:

- Ian Crosbie – Davies Ward Phillips & Vineberg
- Ken Griffin – PwC Canada
- Amanda Heale – Osler, Hoskin & Harcourt LLP
- Josh Jones – Blake Cassels & Graydon LLP
- Angelo Nikolakakis – EY Law LLP
- Sebastien Rheault – Barsalou Lawson Rheault
- Jim Samuel – KPMG
- Carrie Smit – Goodmans LLP
- Jeffrey Trossman – Blake, Cassels & Graydon LLP
- Gwen Watson – Torys LLP

We trust that you will find our submission helpful and we would be pleased to discuss it at your convenience.

Yours very truly,

Ken Griffin
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Jeffrey Trossman
Chair, Taxation Section
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Cc: Brian Ernewein, Assistant Deputy Minister, Tax Legislation Division, Tax Policy Branch, Finance Canada
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Foreign Affiliate Dumping

Budget 2019 proposes to make significant amendments to the so-called "foreign affiliate dumping" or "**FAD**" rules contained in section 212.3 of the Act.

For the reasons described below, the Joint Committee recommends that a number of changes be made to the legislative proposals included in the Notice of Ways and Means Motion.

Background

In 2012, the Government first proposed the FAD rules as a measure designed to address perceived base erosion opportunities available to Canadian subsidiaries of foreign multinational enterprises ("**MNEs**"). Our committee provided extensive input into the design issues with the initially proposed version of the FAD rules, and potential solutions to make the rules workable. Following several rounds of technical revisions, the rules have become largely settled and, we believe, effective in addressing the originally expressed base erosion concerns, though still somewhat cumbersome in certain circumstances.

In many situations, the rules will not unduly interfere with cross-border investments, even though the primary consequence of the rules applying is fundamentally counter-intuitive. Specifically, the FAD rules provide, in the first instance, for a constructive upstream dividend – subject to non-resident withholding tax -- when a corporation resident in Canada ("**CRIC**") is controlled by a non-resident corporation, and the CRIC acquires or makes a downstream investment in a foreign affiliate ("**FA**"). This unintuitive outcome is based on the underlying premise that, absent Canadian tax considerations, the foreign "parent" would have acquired, or made the investment in, the FA directly, rather than through the CRIC, and that the CRIC would have distributed the funds used to make the acquisition or investment to the foreign parent.

As a practical matter, however, the constructive upstream distribution is normally avoided through the "PUC offset" mechanism provided under subsection 212.3(7). This rule usually applies to effectively eliminate a tax attribute – PUC of a cross-border class – rather than imposing withholding tax on a deemed cross-border dividend. Pragmatic supporting rules, including the definition of a "cross-border class" (whose PUC is reduced), the rules permitting reduction of the PUC of a "qualifying substitute corporation" instead of the particular CRIC that made the investment, and the "PUC reinstatement" rules in subsection 212.3(9) have helped in making the FAD rules reasonably workable in many situations. Other critical provisions that have assisted in limiting the inappropriate application of the FAD rules include the deemed non-control rule in paragraph 212.3(15)(a) and the reorganization exceptions in subsection 212.3(18), as well as the "PLOI" rules in subsections 212.3(10) and (11). Overall, the current law, while imperfect, reflects a reasonable balance between the originally expressed concern about base erosion and the need for a reasonable, workable rule that, while extremely complex, does not give rise to anomalous or punitive results in many cases.

Having said that, the existing rules do contain some shortcomings. Most prominently, there is a broad perception among practitioners that the "more closely connected business" or "**MCCB**" exception in subsection 212.3(16) is unduly narrow. This rule conceptually "turns off" the FAD provisions when the circumstances are such that the underlying premise (that the parent MNE would "naturally" have made the investment in the FA directly rather than through the CRIC had tax considerations not been relevant) is likely to be false. In other words, the MCCB exception is designed to carve out situations in which the FA investment truly "belongs" in the CRIC, and where it is not reasonable to suppose that, absent tax considerations, the funds for the acquisition or investment would have been distributed to the foreign parent and used by it to make the acquisition or investment. The Explanatory Notes issued with the original legislation suggested that the MCCB exception would apply in many situations involving CRICs

owned by a private equity ("**PE**") fund, though the stringent and frequently unrealistic conditions imposed by the text of the MCCB exception have often interfered with this apparently intended outcome.

Unfortunately, the MCCB exception was drafted so narrowly that it often cannot be reliably used in practice. The MCCB exception imposes a heavy onus on the CRIC to "demonstrate" that a number of conditions are met. Five detailed, and in some respects subjective[1] conditions must be met for the MCCB exception to apply. These include often inapplicable criteria requiring that the performance evaluation and compensation of the officers of the Canadian company be based on the results of the FA to a greater extent than that of any officer of the foreign parent. There are many situations, under the current law, where the requisite facts cannot be "demonstrated", either because the real facts regarding, for example, performance based compensation are not sufficiently clear, or because it is simply impractical to rely on the nebulous notion that the requisite facts can be "demonstrated" to a sufficiently clear extent to rely on this exception. We mention this in part because we believe it is not reasonable to expect that the broadening of the basic rule that is now being proposed will realistically be mitigated by potential reliance on subsection 212.3(16), as it now stands. We do however provide some recommendations as to how the MCCB exception could be improved, both as it applies to MNEs and as it (or, as we suggest, a separate companion provision) may apply to a CRIC controlled by a non-resident person that is not a corporation.

The core FAD-related proposal in Budget 2019 is to broaden the FAD rules so that they apply not only to a CRIC controlled by a non-resident corporation (such as an MNE), but also to a CRIC controlled by a non-resident individual, including a trust[2]. This clearly represents a change in the basic fact pattern to which the rules could apply. It appears that the original conscious decision to target CRICs that are part of an MNE group has been re-considered.

As a further, and more troubling, measure, it is now proposed that the FAD rules apply in certain circumstances where a CRIC is <u>not</u> controlled by any one person, but could be said to be controlled by a "group" of persons that are non-residents and that do not deal with one another at arm's length; each member of such a group is treated as a deemed "parent". Our comments on this aspect of the proposals are set out below.

In support of these rules is a new series of deemed ownership rules in proposed subsection 212.3(26). As discussed below, these rules inappropriately impute ownership in certain circumstances, and we have some recommendations for changes.

In the remainder of our comments, we will provide specific input into various design issues with respect to the proposed FAD changes. For purposes of these comments, we will accept as a premise that the Government has made a policy decision to make the FAD rules applicable in situations different from the originally conceived fact pattern of a Canadian corporation that is part of an MNE group. Rather than challenging this policy decision, our comments will focus on how to make the rules as workable as possible, and how to minimize collateral damage.

Based on our very helpful conversations with Finance officials, we understand that the fundamental reason for the proposed changes is that it has been determined that similar tax policy concerns to those underlying the existing FAD rules arise where a CRIC is controlled by a non-resident individual. We have inferred from our discussions, as well as the fact that no specific revenue estimate was associated with

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[1] For example, paragraph 212.3(16)(a) requires that it be demonstrated that the business activities of the CRIC "are expected to remain" more closely connected to the business activities of the CRIC than to those of any other foreign group company.

[2] The proposal to extend the FAD rules to situations involving control by a "group of persons" is discussed separately below.

this measure in the Budget papers, that the proposed change is a “base-protection” or “integrity” measure, as opposed to a measure designed to generate a specific amount of expected tax revenue. We also understand that the measure is not aimed principally at fact patterns involving CRICs controlled by PE funds, though such investors may be impacted by the proposals. We have endeavoured to make our comments as constructive as possible in light of this overall understanding.

Control by a Non-resident individual

One key feature of the proposals is to apply the FAD rules to a fact pattern in which there is no non-resident “parent” corporation. This makes the FAD rules potentially applicable to CRICs that are not part of an MNE group. A CRIC controlled by, for example, a non-resident individual will now be subject to the FAD rules.

Under existing law, a foreign enterprise controlled by a non-resident individual could structure its investment into Canada by having the particular individual, rather than a foreign corporate entity controlled by the individual, hold the CRIC’s shares. Under existing law, there may also be some CRICs that are controlled by PE funds structured so that there does not exist a non-resident corporation that controls the CRIC. We will discuss some of the unique aspects of PE investors in a separate section.

The key contextual point to note is that the FAD rules may now apply to private businesses in a much wider range of circumstances than was previously the case. Key relieving provisions, designed with the MNE context in mind, now need to be re-considered in light of this contextual evolution. Among these provisions is the MCCB exception, discussed below.

One fact pattern that is worth considering is the case of a CRIC that is controlled by an individual who is initially resident in Canada, but who then emigrates and becomes a resident of, for example, the United States, or whose shares are bequeathed to a non-resident individual. The CRIC may in some cases have previously established business operations in a foreign jurisdiction, and the individual’s change in residence may even be principally for the purpose of building up the foreign operations of what is really a Canadian-headquartered enterprise.

While we recognize that in some cases the MCCB exception could apply, we question the appropriateness of applying the FAD rules in the first place to investments made by the CRIC in its FAs just because the individual who controls the company has migrated, especially when the migration was for a business or personal purpose. At the very least, we suggest there should be a period of time (we would suggest five years) during which the FAD rules, if otherwise applicable, would be suspended. This would provide a reasonable adjustment period, and would also incentivize the individual to return to Canada within the five-year window.

Recommendation

We recommend there be a relieving provision which “turns off” the FAD rules where the individual who controls the CRIC is a natural person who was previously resident in Canada, but became a non-resident of Canada within the immediately preceding five years. The relieving provision should also apply to a CRIC that is initially controlled by an individual who is a natural person resident in Canada in circumstances where the shares are bequeathed to an individual who is a non-resident of Canada.

De minimis exception

The proposed broadening of the FAD rules to apply to a wider range of private business operations should in our view also be accompanied by some type of *de minimis* exception. Smaller businesses will inevitably find it more difficult to obtain the necessary advanced professional advice to navigate the

complex FAD regime. Due to the design of the FAD rules, an unsophisticated foreign investor could end up with an inappropriately punitive tax consequence – withholding tax on a deemed dividend – just because the investor used a CRIC to make a foreign investment and did not, for example file the "PUC offset" form mandated by paragraph 212.3(7)(d). Likewise, from the Government's perspective, the potentially foregone tax revenues should be limited if the enterprise is sufficiently small. In this regard, as noted above, no specific amount of expected revenue was included in the Budget documents.

We realize there will inevitably be some arbitrariness to any *de minimis* rule. And we also acknowledge that, from a policy perspective, it may be undesirable for the tax system to provide disincentives to the expansion of small businesses. On balance, however, we believe that a *de minimis* exception is justified in the present case as a reasonable balance between protecting the integrity of the tax base and avoiding undue complexity for taxpayers and the Government.

We are not certain precisely what metric makes the most sense for a *de minimis* rule. Possible metrics include the taxable capital of the CRIC's corporate group, similar to the way in which "large corporations" are defined in subsection 225.1(8), though we believe that in the context of the FAD rules the threshold should be higher than that found in subsection 225.1(8). If that metric were to be used, a reasonable cut-off would in our view be $50 million, which is similar to the threshold in the Ontario legislation for corporate minimum tax. Another possible way to structure a *de minimis* rule would be with reference to the aggregate size of the investments made in the year, either alone or together with a cut-off based on taxable capital.

Recommendation

We recommend that a *de minimis* exception be added under which the FAD rules not apply to an investment made by a CRIC that meets a specified *de minimis* test, expressed either with reference to taxable capital, or the aggregate size of investments made in the year, or a combination of such metrics.

New relieving rule for non-corporate controlled CRICs

As noted above, practitioners' experience over the past several years with the existing MCCB exception suggests that it is extremely narrow, and very rarely can be relied upon in practice. In another section, we will discuss some recommended changes to the MCCB exception to more effectively delineate the circumstances in which an MNE's investment in a foreign corporation "belongs" in the CRIC.

Leaving aside the shortcomings of the existing MCCB exception, it is self-evident that it was designed in the context of the original FAD rules, whose scope was focused on MNEs. The existing MCCB exception presupposes the existence of a corporate "parent" having a "business" and "officers" who make decisions about acquisitions and investments, and who are compensated based on the results of various operations. An expansion of the core rules to apply to non-corporate controlled CRICs, where there is no foreign "parent" corporation, necessitates a re-think of the scope of an appropriate exception for investments that properly "belong" in the CRIC.

On balance, we believe there should be a parallel relieving rule that is broader and more flexible than the existing MCCB exception. The parallel rule should be aimed specifically at non-MNE fact patterns. The parallel rule is referred to herein as the "new relieving rule". The new relieving rule, in contrast to the MCCB exception, would not impose an onus on the CRIC to demonstrate that specified conditions are met. Rather, it would focus on the core underlying concept that the FA investment "belongs" in the CRIC.

While there are different ways of articulating such a rule, none of which is perfect, we would suggest that one reasonable approach is to dis-apply the FAD rules where a non-corporate controlled CRIC makes an investment and it is reasonable to consider that none of the main reasons why the investment was

made by the CRIC, rather than by the non-corporate "parent", was to avoid or defer Canadian income tax or withholding tax. We acknowledge that there is an element of uncertainty in a rule such as this. This uncertainty could be mitigated by specifying in the legislation some of the factors that should be considered in determining the "main reasons" why the investment in the FA was made by the CRIC instead of being made by the non-corporate "parent".

To clarify, it would not be sufficient for a taxpayer to escape FAD under the proposed new relieving rule merely because the investment itself has a predominant commercial purpose. Rather, the focus would be on whether Canadian tax considerations sufficiently influenced the decision to make the investment in the CRIC instead of making the investment at the level of the foreign "parent". This is in some respects similar to the originally conceived version of the core FAD rule, as specified in Budget 2012. While the core rule has evolved in a different direction, our judgment is that an anti-avoidance rule based on the "instead-of" concept is an appropriate way to limit the scope of FAD as it might now apply to non-corporate controlled CRICs.

We acknowledge that a relieving rule of this nature would limit the application of the FAD rules to CRICs controlled by non-corporate parents to situations where a main reason for the CRIC making the investment was a Canadian tax benefit. Such an exception might therefore result in the new FAD rules for non-corporate controlled CRICs being narrower than the corresponding rules for corporate-controlled CRICs. However, we would observe that this is reasonable, in view of the fact that, as we understand it, the proposed extension of the FAD rules is in the nature of a base-protection or integrity measure. It is also aligned with our observation that the foreign investment is more likely to "belong" in the CRIC where the CRIC is, in fact, the parent corporation.

Recommendation

A new relieving rule should be added. The rule should provide that the FAD rules do not apply to an investment made by a CRIC in a subject corporation where:

(a) the CRIC is not controlled by a non-resident corporation; and

(b) it is reasonable to consider, having regard to all the circumstances (including the business activities, if any, carried on by the parent, the CRIC, and the subject corporation), that none of the main reasons for the CRIC making the investment, instead of the parent making the investment, was to avoid or defer tax payable under Part I or Part XIII of the Act.

Ownership attribution

Proposed subsection 212.3(26) provides that, in determining whether two persons are related to each other or whether a person is controlled by another person, a trust shall be deemed to be a corporation with 100 issued shares, which are then deemed to be owned by its beneficiaries. Where the trust is a non-discretionary trust, each beneficiary is deemed to own a proportion of such shares in accordance with the relative fair market value ("**FMV**") of the beneficiary's interest in the trust. Where the trust is discretionary, each beneficiary is deemed to own 100 % of such shares. In effect, this new provision may deem a CRIC that is actually controlled by a trust resident in Canada to be controlled by a non-resident person, and therefore subject to the FAD rules. While not entirely clear, we believe that under the proposals, a CRIC that is controlled by a non-resident trust would not be subject to the proposed FAD rules if the trust's controlling beneficiaries are residents of Canada, in accordance with subsection 212.3(15), as proposed to be amended. This outcome, assuming it is intended, should be clarified.

Existing paragraph 212.3(25)(b) attributes ownership of partnership property to a member of the partnership based on the FMV of the member's interest, relative to the FMV of all interests. As noted

above, proposed paragraphs 212.3(26)(a) and (b) adopt a similar approach, by treating the beneficiaries of a non-discretionary trust as owning their *pro rata* share of the underlying trust property, based on relative FMV. However, a trust, unlike a partnership, is a taxpayer, and has a place of residence, typically based on where its "central management and control" resides (i.e., where the "board-level" decisions are really made; typically where the board of trustees meets). Income derived by a trust is not simply allocated to its members, but rather is taxable in the trust, or, if made payable to a beneficiary, in the hands of the beneficiary. Cross-border distributions of trust income are generally subject to withholding tax at rates generally no less than 15% (the same rate as the federal corporate income tax rate) even where treaty rates apply. As a result, it is not clear that Canadian resident trusts should be "looked through" in the same way as partnerships for purposes of the FAD rules.

Proposed paragraph 212.3(26)(c) goes well beyond *pro rata* ownership imputation; it deems each particular beneficiary of a trust to own 100% of the trust's property in any case where the beneficiary's share of income or capital of the trust depends on the exercise of, or failure by any person to exercise, any discretionary power. While it is acknowledged that similar ownership attribution rules appear elsewhere in the Act[3], the impact in those cases is less severe.

Proposed paragraph 212.3(26)(c) would give rise to a clearly inappropriate outcome in some situations. For example, suppose that voting control of a family-controlled Canadian private company rests in a trust under which the trustees have some discretion regarding allocations of income or capital to beneficiaries. Suppose the beneficiaries are the descendants of the company's founder, and suppose that one of these individuals is or becomes a non-resident of Canada, either because the individual is attending university outside Canada, or is working in the business of a foreign subsidiary, or for any other personal or business reason. That one individual, who, as a beneficiary will have no decision-making authority, and who typically will not himself/herself conduct any business activities, will be deemed to control the CRIC, thereby subjecting it to the FAD rules on any downstream investment or acquisition of a non-resident corporation. To make matters worse, the existing MCCB exception will be unworkable in those circumstances (the individual is deemed to be the "parent", but has no business and employs no officers), and the PUC offset rule will not be available because the beneficiary is deemed to own the shares owned by the trust only for limited purposes.

We would also note that deeming each non-resident discretionary beneficiary to own 100% of the shares owned by the trust could lead to multiple incidence of tax on multiple deemed dividends in relation to a single investment.

We believe the appropriate way of avoiding these outcomes is to eliminate proposed paragraph 212.3(26)(c). In the context of the FAD rules, it is simply unreasonable to attribute to a beneficiary ownership of all the property owned by a trust just because the beneficiary's interest is discretionary. Indeed, to the extent the beneficiary's entitlement is subject to a discretion, it is reasonable to conclude that the beneficiary has nothing of value until the discretion is exercised. The trustee could deprive such a beneficiary of any entitlement to income or capital. In any event, the core premise that, absent tax considerations, the investment in the FA would have been made by the discretionary beneficiary is almost certainly false in any such case. There is no reasonable circumstance under which a discretionary beneficiary who is simply a family member, perhaps even a minor, would have made the investment. The fact pattern could not be more different from that of an MNE that decides to have an FA acquired through its Canadian subsidiary, instead of directly, to avoid the extraction of cash by way of a taxable dividend.

We would go further and suggest that proposed paragraphs 212.3(26)(a) and (b) are also unnecessary. If the trust that controls a CRIC is non-resident, then it appears the FAD rules would generally apply

[3] For example, in the thin-capitalization rules and the associated corporation rules.

(subject to subsection 212.3(15), as proposed to be amended) because the CRIC is controlled by a non-resident person. If, on the other hand, the trust that controls a CRIC is resident in Canada, this means that the central management and control of the trust is in Canada. In other words, the CRIC is, in a very real sense, controlled by Canadian resident decision makers. Even if a majority interest beneficiary of the trust is a non-resident (which may be deemed to control the CRIC under the proposed ownership attribution rules), the situation is not analogous to that of an MNE. The premise that the "natural" transaction that would have occurred absent tax considerations is an investment by the non-resident beneficiary is likely to be false; the real control of the investment is vested in the trustees who, in the case of a trust resident in Canada, exercise central management and control in Canada.

We realize that there may be situations in which a trust resident in Canada could be seen to have been interposed in order to circumvent the application of otherwise applicable FAD rules. To address those situations, we would suggest it is more reasonable to add a specific anti-avoidance rule aimed at the interposition of a trust for the purpose of defeating the FAD rules, rather than mechanically deeming beneficiaries to own the trust's property.

In any event, and whether or not the foregoing recommendations are accepted, investments by CRICs controlled by certain types of trusts should be carved out on the basis that the premise of the FAD rules (that the "natural" transaction is an investment in the FA by the foreign "parent") is likely to be false. As examples, we suggest that CRICs controlled by mutual fund trusts (which must be majority Canadian-owned), and testamentary trusts arising on the death of a Canadian resident (which obviously do not acquire shares for tax avoidance purposes) should be excepted either in general or, in the case of such testamentary trusts, at least for a reasonable period such as 5 years.

Recommendation

Proposed subsection 212.3(26) should not be enacted.

To address potential tax avoidance situations involving the use of trusts, a specific anti-avoidance rule should be enacted under which, in respect of a particular investment made by a CRIC in a subject corporation, a non-resident beneficiary of a trust resident in Canada (other than an "excepted trust", described below) that controls the CRIC would be deemed to own shares actually owned by the trust if it is reasonable to conclude, having regard to all the circumstances, that one of the main reasons for the CRIC being controlled by the trust, rather than by the non-resident beneficiary, was to avoid the application of section 212.3 to the investment.

An "excepted trust" would include a mutual fund trust, and a testamentary trust arising on the death of a Canadian-resident individual (at least for a period of 5 years).

Control by a NAL group

Thus far, this submission has addressed the proposal to extend the FAD rules to CRICs controlled by a non-resident person. A distinct, and highly troubling aspect of the proposed changes to the FAD rules is to also extend them to CRICs that are not controlled by any one person, but rather that are controlled (or deemed controlled) by a so-called "group of persons" each member of which is a non-resident person that does not deal at arm's length with each other member of the group (a "**NAL group**"). Each member of such a group, no matter how insignificant, would be deemed to be a "parent".

For some specific purposes, such as for example, the "related person" rules in section 251, the Act currently uses the concept of a "related group" of persons. The concept of a NAL group is novel. We question its appropriateness, especially in the setting of the FAD rules, where the consequences of an

incorrect judgment are the potential application of punitive tax consequences (withholding tax on a deemed cross-border dividend to the so-called "parent" just because a CRIC invested in a FA).

Testing whether two or more persons are "related" is sometimes complex, but at least in most cases a "correct" answer can be arrived at. In contrast, because it is "a question of fact" whether unrelated persons deal at arm's length, there is considerably less clarity. Jurisprudence has tended to limit the "factual non-arm's length" test to situations where (i) one party has *de facto* control over the other, so that it can dictate the terms of a transaction, (ii) parties are subject to the *de facto* control of the same person, or (iii) one party acts as an accommodation party to the other, and essentially does not have opposing interests. However, courts have broad latitude to apply the statutory "question of fact" test. There is in practice a very material amount of inherent uncertainty in the factual non-arm's length determination. If the concept of a NAL group is used, one can reasonably expect significant disputes to arise as to its application.

The broader concept of a corporation being controlled by a "group of persons", rather than a single person, is also relevant in some cases, for example in determining whether there has been an acquisition of control of a corporation for purposes of section 111. Here, it is fairly well accepted that persons will constitute a "group of persons" where they "act in concert" to control the corporation. A common example arises where two or more shareholders, none of whom has control on its own, enter into a shareholders' agreement that sets out the make-up of the board and governance of the corporation. Depending on the circumstances, this could include a genuine 50/50 "joint venture" arrangement where the CRIC simply is the vehicle chosen by the parties for the joint venture. Is it really reasonable to suppose the foreign co-venturers, who have gone to the trouble of forming their joint venture vehicle in Canada, and who have negotiated a comprehensive shareholders' agreement, would "naturally" use a different entity (which would need to have a corresponding shareholders' agreement) when their Canadian venture succeeds at home and decides to expand internationally?

In such cases, we believe it is generally accepted that the members of the "group" will not normally be considered to not be dealing with one another on a non-arm's length basis merely because they act in concert to control the corporation. (This is distinct from the question of whether any one or more members of the group deals at arm's length with the corporation itself). Having said that, if the Act were to be amended to introduce the novel concept of a NAL group in the context of the FAD rules, one wonders whether CRA or a court might see that legislative change as an opening to expand the NAL concept in this context. We believe it is not appropriate to import the factual non-arm's length test here, especially because the consequences of "being wrong" are so draconian.

We would add that the premise of the FAD rules – that the "natural" transaction would have been an investment in the FA by the "parent" (which here means each co-venturer that is a member of the NAL group) rather than the CRIC – seems clearly to be inapplicable. Why would a so-called NAL group, having gone to the trouble of negotiating a comprehensive shareholders' agreement concerning their joint venture vehicle (the CRIC), make an investment in a foreign corporation themselves instead of making it through the CRIC itself? In a very real sense, the CRIC <u>is</u> the "parent", and it is difficult to justify the suggestion that each foreign co-venturer should be a deemed "parent". Furthermore, the MCCB exception is even more difficult to apply in the "group" context; how can the conditions mandated by that exception be tested when the "parent" is not even in a control position, but rather is just a member of a group that controls, and which may not itself have officers or a business?

Moreover, the NAL group concept could expose Canadian based public corporations to the potential application of the FAD rules in situations where they could not reasonably be aware of the fact that certain non-resident shareholders constituting a "group of persons" were considered to not be dealing at arm's length with one another as a factual matter.

Having said all of that, we acknowledge that there is a legitimate concern in ensuring that the expanded FAD rules cannot be avoided simply by "parking" shares in the hands of another person. We believe a reasonable and balanced (though admittedly imperfect) way to address that concern is with a specific anti-avoidance rule aimed at structures which divide ownership of shares of a CRIC for the purpose of defeating the FAD rules.

With respect to the existing FAD rules, it is also to be noted that potential avoidance of the FAD rules by having shares of a CRIC owned by a corporation in the foreign parent's group (e.g., a sister corporation), was addressed in amendments to subsection 212.3(1) enacted in 2017. Furthermore, existing paragraph 212.3(15)(b) already deals with situations where a related group of persons controls a CRIC. Any new specific anti-avoidance rule aimed at "group" control should therefore be directed only at CRICs that are not otherwise controlled by a non-resident corporation.

Recommendation

The proposed extension of the FAD rules to investments made by a CRIC that is controlled by a NAL group, with each member of the group being deemed to be a "parent", should not be enacted.[4] In place of the concept of control by a NAL group, there should be a specific anti-avoidance rule that applies where:

(a) a particular CRIC that is not controlled by a non-resident person makes an investment in a subject corporation;

(b) the particular CRIC is controlled by a group of persons each member of which is a non-resident person that does not deal at arm's length with each other member of the group of persons, and

(c) it is reasonable to conclude, based on all of the facts and circumstances, that one of the main reasons why the particular CRIC was controlled by the group of persons instead of being controlled by a particular non-resident person was to avoid the application of section 212.3 to the investment.

Where the specific anti-avoidance rule applies, the particular non-resident person referred to in (c) would be deemed to control the CRIC and would be deemed to own all of the shares owned by the members of the group of persons, and the PUC offset rules would be available in respect of all such shares to the extent the shares are shares of a cross-border class.

Reorganization rules

Subsection 212.3(18) sets out detailed exceptions to the FAD rules which generally apply to certain internal reorganizations, such as intra-group transfers, amalgamations within a control group and certain other exchanges of securities that qualify for rollover treatment.

Practitioners experienced in the application of these rules are aware of already-existing traps and anomalies. For example, an "internal" amalgamation[5] can give rise to a deemed new "investment" in certain circumstances where one of the amalgamating companies was the target in an acquisition, and therefore was not at all times during the series of transactions within the related group.

In order to accommodate the proposal to extend the FAD rules to situations involving "group" control with multiple deemed "parents", significant changes have been proposed to the text of subsection 212.3(18).

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[4] In this regard, the consequential changes proposed to be made to paragraph 212.3(15)(b) should also not be made.

[5] Other than an amalgamation to which subsection 87(11) applies.

As noted above, we recommend that the concept of group control and multiple deemed parents not be enacted.

If, contrary to that recommendation, the concepts of group control and multiple parents are retained, we would be concerned that the number of potential traps in the reorganization rules could multiply. One example that comes to mind is a situation where the composition of the particular "group of parents" changes, for example where one member of the group transfers its interest to another person (potentially even an internal transfer within that member's own group), or where the relevant relationships evolve such that the composition of the "group" changes for such reasons (for example, two members of a former "group" get into a dispute). This might disqualify an otherwise compliant amalgamation under subparagraph 212.3(18)(c)(ii) on the basis that at some point in the series of transactions one or more predecessors might have been controlled by a different "group of parents" than the group that controls at the time of the amalgamation.

It is only through usage and experience that all of the traps and anomalies with such a provision would be discovered. In other words, it is not reasonable to expect that we or any other commentators can comprehensively itemize all of the likely problems with the "group of parents" concept, as it relates to the already-complex reorganizations rules in subsection 212.3(18).

Recommendation

If, contrary to our recommendation above, the "group of parents" concept is retained, we recommend that there be a further review of subsection 212.3(18) to seek to identify as many anomalies as possible. It may also be helpful to add a broad statement of the purpose of subsection 212.3(18) to the explanatory notes to assist in interpreting unforeseeable fact patterns in a way that properly reflects the underlying policy objectives.

Upstream PLOI

As a consequence of the enactment of the existing PLOI rules, changes were made to the rules applicable to upstream loans made by a CRIC to a non-resident controlling corporation. Specifically, while prior law treated such a loan as a taxable deemed dividend if (generally) it remained outstanding over longer than two year-ends, the decision was made to add the concept of a "pertinent loan or indebtedness" or "**PLOI**", which would be excepted from the normal deemed dividend treatment. This decision in turn was based on the "downstream" PLOI concept which was included in the FAD rules to except investments in subject corporations that are structured as PLOI loans. Essentially, the concept here is that a CRIC that has made a PLOI loan (upstream or downstream) must include in its income no less than a baseline rate of interest, generally being the usual "prescribed" rate for low-interest loans plus 4% (but without rounding).

As currently existing, the upstream PLOI regime applies only to a loan made to a controlling non-resident corporation (or non-resident members of the controlling corporation's group). This makes sense under existing law because the FAD regime applies only to CRICs controlled by a non-resident corporation.

It is now proposed to broaden the FAD regime so that it will apply where there is a non-resident "parent" that is not a corporation. We would suggest that a corresponding change be made to the upstream PLOI regime to permit PLOI loans to be made by a CRIC to any non-resident person that is a "parent" for purposes of the FAD rules.

Recommendation

The upstream PLOI rules in subsections 15(2) and 15(2.11) should be amended to permit PLOI loans to be made by a CRIC to any non-resident person that is a "parent" for purposes of the FAD rules.

PE Funds

Over the past two decades, inflows of equity capital from PE funds have become increasingly important to the Canadian economy. PE funds often own controlling or minority stakes in Canadian businesses. We believe it is desirable that these capital inflows not be unduly impeded by the inappropriate application of the FAD rules to genuine commercial transactions.

US based PE funds are normally organized as limited partnerships, almost invariably with a general partner that is a US limited liability company ("**LLC**"). Investors in PE funds typically include US-based pension funds, charitable organizations, universities and high net-worth individuals, as well as similar investors, and sometimes state-owned entities, based in other countries.

From the perspective of the existing FAD rules, the position implicitly adopted in the explanatory notes for the existing MCCB exception is that a CRIC controlled by such a typical PE fund would be considered to be controlled by a non-resident corporation, namely the general partner, which as noted is typically organized as an LLC.

On one view, the "real" owners of a CRIC controlled by a PE fund are the disparate investors, none of which is in a control position, and many if not all of which may not be non-resident corporations. Normally, the general partner's economic interest is relatively small (though it could grow over time as "carried interest" accrues on successful investments). Applying the ownership attribution rules in subsection 212.3(25), one would have thought that in most cases there would be no single non-resident corporation that would have *de jure* control if each partner owned its *pro rata* share of the CRIC's shares. Having said that, we acknowledge the Government's view appears to be that because the general partner in fact has the power to vote all of the shares owned by the partnership by virtue of the provisions of the partnership agreement, it would be considered a non-resident corporation that controls the CRIC, and we will accept this premise for purposes of our comments here.

We have discussed the fact that Finance is aware of certain situations in which PE funds investing in CRICs have utilized structures in which the general partner is not a non-resident corporation, thereby not becoming subject to the FAD rules. It is suggested that such an outcome is not necessarily inappropriate, as a PE fund is really just a pooling vehicle for disparate investors, and cannot be likened to an MNE that would "naturally" have extracted cash from its Canadian subsidiary to make the investment in the subject corporation. In any event, our experience is that these arrangements are quite rare, as the use of an LLC as the general partner is very pervasive and is considered the most appropriate way to obtain limited liability for the principals on a basis that is fiscally transparent for US tax purposes.

While obviously the specific facts vary from one PE fund to another, there are some common features shared by many PE funds, which clearly differentiate them from MNEs. As noted, PE funds are pooling vehicles for disparate investors looking to benefit from the experience, skill and acumen of the individuals who comprise the "sponsor". These individuals will frequently be experienced "deal people" who, through their knowledge and networks, are able to identify appropriate investments, negotiate favourable transaction terms, and develop and implement an effective business plan for the target company.

It is typical for PE funds to maintain separate chains of ownership for different portfolio businesses. This facilitates both the structuring of equity investments by those involved in the particular business, and a future exit from that particular portfolio investment. Often a specific vehicle is formed for a particular portfolio investment which facilitates an "opt-out" that certain investors might negotiate.

When a foreign based PE fund decides to acquire a Canadian-based portfolio company that is not an "add-on" to an existing already-owned business[6], the acquired CRIC will typically be the true "parent" company. If it is then determined appropriate to expand the acquired CRIC's business by making an "add-on" investment, for example by acquiring a similar or complementary business in another jurisdiction, it is in general most "natural" for the CRIC itself to be the acquiror. Yet the FAD rules, where applicable, pre-suppose that the "controlling" general partner is the "natural" acquiror. This premise seems inappropriate in the context of many PE fund investments.

The situation is further exacerbated by the fact that it will often be very difficult to clearly delineate which person "decided" to make the further investment. Sometimes the transaction will be identified by the "deal people" who comprise the sponsor, due diligence may be conducted by "business people" who work for the CRIC, or for an FA of the CRIC, and the negotiation and consummation of the transaction may be a joint effort. As discussed below, these fact patterns often make it difficult to confidently rely upon the existing MCCB exception.

As discussed below, one way of addressing these issues is by liberalizing the MCCB exception. More generally, we would suggest that a conscious decision be made as to whether and how the FAD rules should apply to collective investment vehicles, including PE funds. Once this decision is made, clear and workable rules should be drafted to clarify precisely how the rules should work for such vehicles. Apart from our recommendations below regarding the MCCB exception, we do not have a specific recommendation here, but would be pleased to discuss this further.

Amendments to existing MCCB exception

As noted above, we recommend that a new relieving rule be enacted to address situations involving non-corporate controlled CRICs.

In case this recommendation is not accepted, or even if it is, we would independently recommend that changes be made to make the MCCB exception more workable. As noted above, practitioners have found the existing MCCB exception to be too narrow to be usable in many cases even where an investment objectively "belongs" in the CRIC.

The basic structure of the MCCB exception is problematic. The rule requires the taxpayer to "demonstrate" compliance with inflexible requirements regarding the officers that had and exercised principal decision-making authority, and with respect to their performance evaluation and compensation. The concept of which officer had "principal decision-making authority" in respect of the making of an investment presupposes a very formal and clear organizational decision-making process. While in some MNE groups it may be clear exactly which individual decided to make the investment, this is often not the case.

In the PE context, as noted above, the decision to invest may be a joint decision into which critical inputs are provided by both the "deal people" who comprise the sponsor, and the "business people", who work for the CRIC and are resident in Canada, or who work for an FA of the CRIC and reside outside Canada. It may happen that people who work for an FA based in a European country (say, France), reside in another European country (say, Switzerland).

As currently drafted, the availability of the MCCB exception seems to turn critically on the determination of precisely which individual "signed off" on the investment, and where exactly that individual resides.

[6] If the PE fund already owns a business conducted by a non-resident corporation, it would often be natural for that non-resident corporation to acquire the CRIC. In that case, the non-resident corporation would (appropriately) be the "parent".

This introduces an element of arbitrariness in some cases; one might rightly ask why it should matter whether the decision maker lives in France (the FA jurisdiction) or across the border in Geneva, Switzerland.

For Canadian based public corporations, the ambiguity about what constitutes "principal decision-making authority", combined with the expansive definition of "office" in the Act may give rise to material uncertainty about whether the MCCB will be satisfied if the "investment" is sufficiently large that the board of directors is required to approve the transaction. In such a case, the ability to rely on the MCCB could turn on whether the majority of the board members happen to be resident in Canada, notwithstanding the clear connection of the subject corporation's business with the public corporation's business. In addition, in many cases the Canadian public corporation will not have access to detailed information about the businesses of its shareholders, an issue that will be compounded if the control by a NAL group concept (or a similar concept) were to be adopted. In this context, we suggest it would be helpful to clarify that where the management of a Canadian based public corporation considers and recommends an "investment", those individuals would generally be the persons with "principal decision-making authority" in respect of the investment, notwithstanding that the board of directors of the corporation are required to consider and approve such investment.

In family-controlled companies, the problems with the MCCB will often be compounded. The controlling individuals may consult a wide range of internal and external advisors in connection with a potential acquisition or investment. There is often less formality in the decision-making process than would be observed in a public company. The factual question of exactly who decided is therefore often blurry. This inherent ambiguity might be more tolerable if not for the clear statutory onus that is placed on the CRIC to "demonstrate" that the requisite conditions are met.

We would suggest that if the business of the subject corporation is more closely connected to that of the CRIC and its subsidiaries, it is hard to understand why, from a tax policy point of view, the question of who precisely "signed off" on the investment should be so pivotal. We believe the concept here is that the rules are attempting to measure whether the "real" decision was made by the foreign parent. This is a concept that might make some sense in some sophisticated MNE groups, such as large foreign-based multinationals. We do not believe it is reasonable to expect similar formality in decision making within private companies. At the very least, a modified and less stringent test, sensitive to this reality, should apply where the CRIC is not controlled by a non-resident corporation whose shares are listed or traded on a stock exchange.

These problems are compounded by the requirements regarding the performance evaluation and compensation of the officers who are determined to have had and exercised principal decision-making authority. Paragraph 212.3(16)(c) effectively denies an otherwise available exception where the requisite connection between those individuals' performance evaluation and compensation and the results of operations of the subject corporation cannot be demonstrated. This requirement pre-supposes the existence of formalized performance evaluations and a bonus or similar arrangement under which the compensation entitlement of the relevant officers needs to be clearly and demonstrably based on results of the operations of the subject corporation to a greater extent than the bonus entitlement of any officer of the foreign parent group. There may be some MNE groups that have formalized performance evaluation and compensation arrangements that could potentially comply with this very rigid test, but that may be exceptional.

In many private companies including family owned businesses, there may be no formalized performance evaluations or bonus arrangement. We believe the purpose of factoring compensation into the MCCB exception is to test whether an investment really and truly belongs in the CRIC. While we can understand this notion on a theoretical level, we would observe that it has had the effect of inappropriately (almost) reading the MCCB exception out of the Act in all but the very clearest cases, often involving publicly

traded MNEs. On balance, we believe that the existence of this requirement should be re-thought, at least where the controlling non-resident is not a publicly traded MNE.

After considerable reflection, and having regard to practitioners' experience over the past several years, we would recommend that the MCCB be re-formulated to be more flexible. As noted below, we recommend that the specific conditions now listed in paragraphs 212.3(16)(b) and (c) be converted into "factors" to be referred to in ascertaining whether or not the relevant businesses are more closely connected.

Recommendation

The core requirement in subsection 212.3(16) should simply be that the business of the subject corporation be more closely connected to the businesses of the CRIC and its FAs than to the business, if any[7], of the non-resident parent.

The conditions in paragraphs 212.3(16)(b) and (c) should be replaced with a list of factors. The statutory rule should state that the "more closely connected" determination should be made having regard to all the circumstances, including specific enumerated but non-exhaustive factors. These factors could include:

(i) the extent to which the business activities of the subject corporation involve the supply of similar products or the rendering of similar services to the products supplied or services rendered, as the case may be, by the CRIC group[8];

(ii) the extent to which the businesses of the subject corporation and that of the CRIC group are connected, in the sense that one such business supplies inputs or outputs to the other;[9]

(iii) the extent to which the principal decision-makers in respect of the particular investment in the subject corporation are resident, and working principally in, Canada or in a country in which a "connected affiliate" (within the meaning of existing subparagraph 212.3(16)(b)(ii)) is resident (and for this purpose, where a particular individual works principally in a particular country (other than Canada) but is resident in another country, the particular individual shall be considered resident in the particular country); and

(iv) the extent to which the aggregate economic entitlements of the individuals referred to in (iii) (whether derived through compensation arrangements or through one or more equity interests or otherwise) depend to a greater extent on the results of operations of the subject corporation than the economic entitlements of officers of the non-resident corporation, if any, that is the "parent" of the CRIC;

It may be appropriate for other enumerated factors to be included, and in any event, the listed factors should clearly be non-exhaustive.

It should also be considered whether there should be explicit recognition, in the statute or at least in the Explanatory Notes, that decision-making and compensation arrangements in some organizations, such

[7] With the expansion of the FAD rules to non-corporate controlled CRICs, it is important that it be explicitly acknowledged that the "parent" may have no business.
[8] The "CRIC group" here is meant to refer to the CRIC itself, related corporations resident in Canada, and controlled FAs of the CRIC or such related corporations.
[9] It will be recognized that factors (i) and (ii) above are similar to statements in the Explanatory Notes relating to the initial enactment of subsection 212.3(16).

as PE funds and private companies, may be less formal than in large public MNEs, and that the MCCB exception should be applied in a manner that accommodates such less formal business structures.

We also recommend that the requirement for the CRIC to "demonstrate" adherence to the MCCB exception be eliminated. This wording is unnecessary. Whenever a matter is in Tax Court, a taxpayer already bears a factual onus to disprove any factual assumptions made by the Minister in assessing. The further tilting of the MCCB exception against the taxpayer by affirmatively requiring facts to be demonstrated is unnecessary.

Proposed Changes to “Derivative Forward Agreement” (“DFA”) Definition

The Budget proposes changes to the “commercial transaction exception” (“**CTE**”) to the DFA definition in subsection 248(1).

The CTE appears in subparagraph (b)(i) of the DFA definition. Without this exception, ordinary purchase agreements with an interim period between signing and closing of more than 180 days could have been treated as DFAs. This would have been possible where there is a difference (the “**Difference**”) between

(i) the fair market value (“**FMV**”) of the underlying property (“**UP**”) at closing, and

(ii) the purchase price paid for the UP,

that is attributable to changes in the FMV of the UP between signing and closing, or to revenue, income or cashflow in respect of the UP. Where the Difference is based on the UP itself – and not on some disconnected “reference security” - it is not appropriate that the agreement constitute a DFA.

For this reason, the CTE generally excludes from the DFA definition a purchase agreement under which the Difference:

> “is attributable, in whole or in part, to an underlying interest (including a value, price, rate, variable, index, event, probability or thing) <u>other than</u> (i) revenue, income or cashflow in respect of the property over the term of the agreement, changes in the fair market value of the property over the term of the agreement, or any similar criteria in respect of the property …”

The Budget documents state that a structure has been developed that attempts to misuse the CTE, by enabling an “Investor Fund” to realize an economic return that includes underlying taxable income (such as interest, dividends or trust distributions of income) but which is taxed entirely as a capital gain. A specific legislative measure is proposed to address this situation.

In particular, it is proposed that the CTE be narrowed. Under the proposals, the CTE would be entirely inapplicable where three conditions are met – very generally,

> (A) the UP is a Canadian security (or a partnership interest deriving its value from a Canadian security),
>
> (B) the seller is either a financial institution or a so-called “tax-indifferent investor”, and
>
> (C) “it can reasonably be considered that one of the main purposes of the series of transactions or events, or any transaction or event in the series, of which the purchase agreement is part is for all or any portion of the capital gain on a disposition of a Canadian security referred to in clause (A) - as part of the same series of transactions or events - to be attributable to amounts paid or payable on the Canadian security by the issuer of the Canadian security during the term of the purchase agreement as
>
> > (I) interest,
> >
> > (II) dividends, or
> >
> > (III) income of a trust other than income paid out of the taxable capital gains of the trust.”

Where these three conditions are met, the CTE will not apply, and the purchase agreement will be a DFA.

As a result, under paragraph 12(1)(z.7), the purchaser will be required to include in its income from a business or property in the year of closing of the transaction the portion of the Difference that is attributable to an "underlying interest" other than an underlying interest described in (b)(i)-(iii). Where the narrowed version of the CTE does not apply, essentially the entire Difference will be taxed as ordinary income.

We have the following comments on the proposed legislative language.

Consequence of Denial of Otherwise Available CTE

First, we suggest that the appropriate consequence of failing to meet the CTE solely as a result of the new limitation is that the portion of the purchaser's return that is attributable to ordinary income, such as dividends, that have been converted into capital gains should be taxed as ordinary income. As drafted, however there is an argument that the analysis is binary – once it is determined that the CTE does not apply, because some portion of underlying income has been converted into capital gains, the entire Difference, even the portion referable to genuine appreciation in value of the UP, will be taxed as ordinary income.

Consider a situation where Investor Fund enters into a forward purchase agreement to acquire the UP at a price equal to initial FMV (say $100) minus income distributions made on the UP between signing and closing. Suppose the amount of such distributions is $5, and suppose further that the UP has appreciated in value to $120 by closing. Investor Fund would acquire the UP at a cost of $95 ($100 - $5). The entire amount by which the FMV of the UP exceeds such cost (i.e., $25) would be included in Investor Fund's income under paragraph 12(1)(z.7). We would suggest that the appropriate consequence of the CTE being denied in this example is that the portion of the excess that is attributable to income distributions on the UP ($5) should be taxed as ordinary income.

We would therefore recommend that the wording of paragraph 12(1)(z.7) be changed to provide that where a purchase agreement would have been a CTE but for clauses (A) to (C) of subparagraph (b)(i) of the DFA definition, the amount of the income inclusion be that portion of the Difference as is equal to the total amount of income distributions paid or payable on the UP between signing and closing.

Inappropriate use of the "Tax-Indifferent Investor" ("**TII"**) Definition

One pre-requisite for the application of the proposed denial of an otherwise available CTE is that the seller be either a financial institution (as defined in subsection 142.2(1)) or a TII.

The TII definition was added in 2016 as part of the enactment of the "synthetic equity arrangement" ("**SEA**") rules. Indeed, paragraph (b) of the TII definition refers specifically to a non-resident that is not a person to which all amounts paid or credited under an SEA may reasonably be attributed to the business carried on by the person in Canada through a permanent establishment. This reference made sense when the only place in which the TII definition was used was in the context of the SEA rules. However, it is suggested that a modification is needed to apply this branch to the DFA rules.

In particular, we recommend that paragraph (b) refer to payments under either an SEA or a DFA, as the case may be, that are connected to a Canadian permanent establishment.

Paragraph (c) of the TII definition includes any discretionary trust. It is counter-intuitive to suggest that every discretionary trust is tax-indifferent. The beneficiaries of a discretionary trust might be taxable persons resident in Canada.

Paragraphs (d) and (e) refer respectively to partnerships and non-discretionary trusts in which more than 10% of the interests (by fair market value) are held by TIIs referred to in paragraphs (a) or (c) (or (b) in the case of partnerships).

For example, a TII would include a partnership with two partners – one a taxable Canadian corporation ("**TCC**") holding, say 85% of the equity, and the other a tax exempt registered pension fund ("**RPP**") holding 15%. Consider a situation in which such a partnership owns 100% of the shares of another taxable Canadian corporation ("**Canco**"). Suppose the partnership agrees to sell the Canco shares to "**Acquireco**", an unrelated taxable Canadian corporation, under an agreement having an interim period between signing and closing of more than 180 days (for example because of a lengthy process of obtaining regulatory approval for the sale). Suppose the FMV of the Canco shares at signing is $100 and that the FMV of the Canco shares at closing is $120. Suppose Canco pays a dividend to the partnership during the interim period, and suppose also that TCC's share of the dividend is determined to be subject to re-characterization as a capital gain under subsection 55(2).

In this example, TCC will realize a capital gain (under subsection 55(2)) that arguably is "attributable" to the dividend paid during the interim period. Would it then follow that the Difference of $20 ($120 minus 100) would be taxed immediately as ordinary income in the hands of Acquireco? Obviously, that would be an inappropriate result.

It is suggested that the source of the problem here is the use of the TII definition. If the partnership had not been regarded as a TII, the CTE exception would have applied.

We therefore recommend that subclause (B)(I) be modified to refer only to (i) a tax exempt person, or (ii) a non-resident person, other than a person to which all amounts paid or credited under a particular purchase agreement referred to in the DFA definition may reasonably be attributed to a business carried on in Canada through a permanent establishment in Canada. If Finance is concerned about trusts and partnerships being used to defeat the DFA rules, there could also be a specific anti-avoidance rule for partnership/trust structures that are designed to defeat the rules, but it is not appropriate to treat all discretionary trusts and all partnerships/trusts with more than 10% owned by tax exempts as TIIs for this purpose.

Transfer Pricing Measures

1. Ordering of Application of the Transfer Pricing Rules

Introduction

In Budget 2019, the Government states that instances have arisen wherein both the transfer pricing provisions in Part XVI.1 and other provisions of the Act may apply to determine the quantum or nature of the same amount for purposes of computing tax under the Act. In such cases, questions have arisen as to whether adjustments made under Part XVI.1 take precedence over the adjustments made under the other provisions of the Act. Budget 2019 suggests that this can have various implications, including with respect to the calculation of penalties imposed under Part XVI.1.

To address this potential concern, the Government intends to amend the Act to provide that the transfer pricing rules in Part XVI.1 take priority over any other provision of the Act. Budget 2019 proposes to implement this change by introducing new subsection 247(1.1) which provides that:

> (1.1) For the purpose of applying the provisions of this Act, the adjustments under Part XVI.1 shall be made before any other provision of the Act is applied.

Subsection 247(8) of the Act, which contains a more limited ordering rule, will be concurrently repealed. The amendments will apply to taxation years that begin on or after March 19, 2019.

The Proposed Amendments are Circular and Introduce Confusion

As currently proposed, new subsection 247(1.1) is circular and would conflict with the current wording of subsection 247(2), which is the provision that authorizes the Minister to make a transfer pricing adjustment. In particular, the mid-amble of subsection 247(2) provides that if the conditions of either paragraph 247(2)(a) or 247(2)(b) are satisfied, then:

> <u>any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period</u> <u>shall be adjusted</u> (in this section referred to as an “adjustment”) to the quantum or nature of the amounts that would have been determined if …
>
> [emphasis added]

Thus, an adjustment under subsection 247(2) must be to an amount that would be determined by applying the provisions of the Act, other than sections 247 or 245. This necessarily means that the other provisions of the Act must first be applied to determine the particular amount, and then subsection 247(2) authorizes an adjustment to the quantum or nature of that amount. New subsection 247(1.1) is inconsistent with this approach because it provides that the adjustments referred to in subsection 247(2) must be made *prior to* applying the other provisions of the Act.

While the Government has indicated that new subsection 247(1.1) will provide greater certainty in the application of the income tax rules, the manner in which this new subsection has been drafted, and its inconsistency with the apparent policy expressed in the mid-amble of subsection 247(2), may lead to additional interpretive uncertainty, confusion, and administrative burden to the Canada Revenue Agency

and taxpayers. Based on the clear words of subsection 247(2), the original policy of the provision was that transfer pricing adjustments be made *after* the application of all other provisions of the Act, with the exception of GAAR. Even if the drafting circularity were to be resolved, it is unclear whether undesired implications may arise from attempting to make transfer pricing adjustments in a legislative vacuum, as would be the case if section 247 were to apply before determining the amounts that would otherwise arise pursuant to the normally operating provisions of the Act, including rollover, deeming and non-recognition rules.

We are unclear as to the practical outcome sought with this new ordering rule. If the Government's object is to clarify that adjustments under section 247 take precedence over adjustments that could potentially arise under other, particular provisions of the Act (e.g., paragraph 18(1)(a) or paragraph 20(1)(c)), then a more targeted approach could be taken by retaining subsection 247(8) and expanding it to include those other provisions. Such an approach would resolve the above circularity and interpretive issues with subsection 247(1.1) as it is currently proposed.

While we acknowledge that Finance officials have stated that the imposition of penalties was not the sole purpose of the proposals, we would observe that this objective could be achieved by simply providing that, for purposes of computing transfer pricing penalties, where an adjustment could have been made under subsection 247(2), but for the prior application of another provision of the Act in respect of the same amount, the amount of the taxpayer's "transfer pricing income adjustment", "transfer pricing capital adjustment", "transfer pricing income setoff adjustment" or "transfer pricing capital setoff adjustment", as the case may be, are to be computed as though the adjustment were made under subsection 247(2).

2. Expansion of Extended Reassessment Period

Introduction

Budget 2019 proposes to amend the extended reassessment period in subparagraph 152(4)(b)(iii) such that the definition of "transaction" in subsection 247(1) of the Act applies for purposes of subparagraph 152(4)(b)(iii). The effect of this amendment would be that transactions, arrangements or events involving a taxpayer and a non-arm's length non-resident would be subject to the extended reassessment period in subparagraph 152(4)(b)(iii). The amendment is proposed to apply to taxation years for which the normal reassessment period ends on or after March 19, 2019.

The Effective Date is Inconsistent with Past Practice and Introduces Uncertainty

The Government's past practice with respect to amendments that extend limitation periods has been to make such amendments effective for taxation years that end on or after the amendment is announced. For example, paragraph 152(4)(b.1) and (b.2), which extended the limitation period in respect of certain tax shelters and reportable transactions, were announced in the 2013 Federal Budget on March 20, 2013. These amendments were made applicable to taxation years that ended on or after March 20, 2013.[10] Similarly, paragraph 152(4)(b.3), which extended the limitation period in respect of certain dispositions of real property, was announced in October 2, 2016 as part of certain measures relating to Canada's housing market. This amendment was made applicable to taxation years that ended on or after October 2, 2016.[11]

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[10] *Economic Action Plan 2013 Act, No. 2*, SC 2013, c 40s. 67(6).

[11] *Budget Implementation Act, 2017, No. 2*, SC 2017, c 33, s 62(4).

In addition, the 2018 Budget changes were also prospective. In particular, clause 152(4)(b)(iii)(B) was made applicable only to taxation years beginning after February 26, 2018 (Budget Day), and new paragraph 152(4)(b.4) applies only in respect of losses for a taxation year that ends after Budget Day.

We recommend that the amendment in Budget 2019 to paragraph 152(4)(b)(iii) should be made applicable to taxation years ending on or after March 19, 2019, rather than to taxation years for which the normal reassessment period ends on or after March 19, 2019. Such an approach would be consistent with past practice and would also promote certainty and finality.

We also note that, even as amended, subparagraph 152(4)(b)(iii) might apply in different circumstances than those that could potentially invite an adjustment under subsection 247(2). Consider whether, rather than the expanded wording currently proposed, subparagraph 152(4)(b)(iii) could be revised to align more closely with the objective of extending the reassessment period for transfer pricing adjustments, for example by simply providing for a 6- or 7-year period to make adjustments under subsection 247(2).