Comité mixte sur la fiscalité
de l'Association du Barreau canadien
et de l'Institut Canadien des Comptables Agréés

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Le 8 juin 2012

Monsieur Brian Ernewein
Directeur général, Division de la législation de l'impôt
Direction de la politique de l'impôt
Ministère des Finances du Canada
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Objet : Budget fédéral de 2012 – Propositions concernant la fiscalité internationale

Monsieur,

Vous trouverez ci-joint notre mémoire sur les propositions législatives sur la fiscalité internationale présentées dans le budget fédéral déposé le 29 mars 2012, qui visent à modifier la *Loi de l'impôt sur le revenu*. Nous vous remercions de nous donner l'occasion de commenter ces propositions.

Notre mémoire porte sur deux types de propositions : les propositions concernant ce que l'on appelle les «opérations de transfert de sociétés étrangères affiliées», et les propositions concernant les «règles de capitalisation restreinte».

Opérations de transfert de sociétés étrangères affiliées

Nous comprenons que les propositions relatives aux opérations de transfert de sociétés étrangères affiliées visent à mettre un terme à certaines opérations perçues comme abusives, mais nous craignons sérieusement qu'elles aient une portée allant bien au-delà de l'objectif législatif et que, dans certaines circonstances, elles aient des conséquences injustes ou non voulues, qui nuiraient à l'ensemble de l'économie et à l'assiette fiscale du Canada.

Comme nous l'expliquons plus en détail dans notre mémoire, nous croyons qu'il faudrait réviser ces propositions pour établir un meilleur équilibre entre l'objectif du gouvernement de protéger l'assiette fiscale canadienne d'une part, et l'appui important accordé par le gouvernement aux échanges et aux placements transfrontaliers d'autre part. Nous croyons notamment que ces propositions :

- ne devraient pas toucher les opérations qui ne sont pas essentiellement mues par des considérations fiscales et qui, par conséquent, n'ont pas d'effet néfaste substantiel sur l'assiette fiscale canadienne;
- devraient être simplifiées et clarifiées à de nombreux égards, entre autres par l'ajout d'exceptions visant certaines situations très claires;
- ne devraient pas entraîner une imposition double ou autrement démesurée.

Nous concevons qu'il est difficile d'élaborer une législation qui concilie adéquatement les divers objectifs pertinents dans le contexte. D'ailleurs, les membres du Comité mixte ont eux-mêmes longuement débattu les propositions lors de la préparation de ce mémoire.

Certains membres sont d'avis qu'il faut conserver le libellé du critère de «l'objet commercial» tel qu'il est formulé à l'alinéa proposé 212.3(1)c), toutefois sans les facteurs précisés au paragraphe proposé 212.3(5). Les facteurs à prendre considération seraient plutôt déterminés par l'Agence du revenu du Canada et les tribunaux, compte tenu de l'ensemble des faits propres à chaque cas.

Par ailleurs, nous comprenons qu'il n'est pas dans l'intention du ministère des Finances que l'alinéa proposé 212.3(1)c) constitue – à la manière de la définition de l'opération d'évitement énoncée au paragraphe 245(3) – le principal critère de l'objet commercial suivant lequel les facteurs commerciaux sont comparés aux facteurs fiscaux. Il nous semble plutôt que les termes employés à l'alinéa proposé 212.3(1)c), avec les facteurs précisés au paragraphe proposé 212.3(5), visent seulement à déterminer si le placement effectué par une société résidente canadienne l'a été pour des motifs commerciaux véritables (c'est-à-dire des motifs autres que fiscaux) et si, compte tenu uniquement de ces motifs, il était raisonnablement approprié que le placement soit effectué plutôt par la société canadienne que par la société mère étrangère ou par une autre société non résidente avec lien de dépendance.

La compréhension que nous venons d'exposer est le principal fondement de notre mémoire. Nous avons aussi été guidés par la conviction que l'analyse doit faire intervenir la question de l'existence ou non d'un avantage fiscal canadien substantiel. Sinon les propositions pourraient avoir une portée allant bien au-delà de l'objectif du gouvernement de protéger l'assiette fiscale du Canada et compromettre indûment son objectif de favoriser les opérations et les placements transfrontaliers.

Compte tenu de ce qui précède, notre mémoire présente un certain nombre de recommandations détaillées sur la réorientation du critère de l'objet commercial vers un critère en deux volets : le premier qui concernerait le caractère non fiscal du placement, et le deuxième qui porterait sur la question de savoir si le placement ou la série d'opérations en cause donne lieu à un «avantage fiscal net» substantiel au Canada. Notre mémoire contient également des recommandations à l'égard de certaines exceptions visant des situations très claires; recommandations qui, à notre humble avis, se révèlent pertinentes tant sur le plan général qu'en ce qui concerne l'équilibre global de la partie en cause de notre régime de fiscalité internationale.

Comme il est indiqué dans le budget, les propositions s'inspirent dans une certaine mesure du rapport du Groupe consultatif sur le régime canadien de fiscalité internationale (le «rapport du Groupe consultatif»). Le budget fait référence à ce rapport dans une description de certains types d'opérations mettant en cause des sociétés étrangères affiliées qui «constituent une forme d'abus», à savoir des opérations qui «réduisent l'assiette fiscale canadienne sans vraiment apporter d'avantage économique aux Canadiens». Il est également mentionné dans le budget que le Groupe consultatif a recommandé «qu'une mesure ciblée soit adoptée pour mettre un terme à ces opérations tout en veillant à ce que les opérations commerciales véritables puissent continuer». Cependant, à certains égards, les propositions semblent aller bien au-delà des recommandations formulées dans le rapport du Groupe consultatif, alors qu'à d'autres égards, elles ne vont pas assez loin.

Plus précisément, ces propositions semblent cibler plus que les ententes de transfert de dette dont il est question dans le rapport du Groupe consultatif, en ce sens qu'elles visent aussi les cas où une société résidant au Canada («société résidente») contrôlée par une société mère étrangère effectue, dans une société étrangère affiliée, un placement qui est financé (directement et indirectement) sans endettement ou dont le revenu qui en est tiré est entièrement imposable, sans égard au mode de financement. Bien que ces deux situations puissent donner lieu à des avantages fiscaux, nous croyons qu'elles sont très différentes et qu'en tentant de les traiter au moyen d'une règle unique, on obtient les problèmes de structure et de rédaction que nous avons observés lors de la préparation de notre mémoire. À notre avis, la règle, telle qu'elle est formulée actuellement, semble avoir une portée tantôt trop large et tantôt trop étroite compte tenu des objectifs en matière de politiques du gouvernement.

En outre, nous constatons que les propositions ne donnent pas suite aux recommandations du rapport du Groupe consultatif quant à l'élargissement du régime d'exemption et à l'objectif de réduire ou d'éliminer les retenues d'impôt sur les dividendes (que ce soit en général ou uniquement à l'égard des placements des sociétés étrangères affiliées qui sont touchées par ces propositions). En conséquence, telles qu'elles sont actuellement formulées, les propositions s'appliqueraient au placement dans une société étrangère affiliée considéré comme n'appartenant pas à la société résidente, de sorte que cette dernière serait effectivement réputée avoir distribué le placement à la société mère étrangère aux fins de la retenue d'impôt pour la société mère étrangère, mais continuerait d'être imposée à l'égard du revenu généré par le placement et de tout gain en capital découlant de sa cession (sous réserve des règles relatives au «surplus exonéré»), et la société mère continuerait d'être assujettie à des retenues d'impôt à l'égard des distributions futures relatives à ce placement.

Nous soutenons respectueusement que cette approche ne permet pas d'assurer l'équilibre global de notre régime de fiscalité internationale, et qu'elle contribue à créer ce que l'on pourrait appeler une «confusion des moyens». À notre avis, le fait de traiter un placement donné dans une société étrangère affiliée comme s'il n'appartenait pas à une société résidente au motif que la société résidente est mandataire de la société mère étrangère et à imposer ces deux sociétés à l'égard du même placement crée de la confusion. D'autres éléments des propositions sont aussi source de confusion des moyens. Notamment, nous croyons que le traitement des placements entièrement imposables, y compris des prêts portant intérêt, crée une confusion considérable. La confusion concerne à la fois des questions fondamentales et des questions plus techniques. Sur le plan technique et quant à la cohérence d'intervention, la relation entre les propositions et les règles des articles 15 et 17, notamment, n'est pas claire. Sur le plan plus fondamental, nous comprenons difficilement comment on peut justifier l'application de ces propositions (et de certaines règles existantes) en invoquant la protection de l'assiette fiscale du Canada alors qu'elles pourraient s'appliquer à des placements non susceptibles d'éroder cette assiette fiscale.

C’est naturellement au gouvernement qu’appartient la prérogative de l’établissement et de la mise en œuvre de la politique fiscale, et la discrétion d’accepter ou de rejeter les recommandations que peuvent faire diverses parties prenantes. Nous avons donc formulé nos recommandations en tentant de garder à l’esprit notre compréhension des objectifs déclarés du gouvernement. Nous résumons ci-dessous nos recommandations les plus importantes et la perspective générale reflétée dans ce mémoire.

- Le critère de «l’objet commercial» devrait être remplacé par un critère en deux volets, dont l’un concerne uniquement la nature commerciale (compte tenu de l’ensemble des facteurs pertinents plutôt que d’une liste restreinte), et l'autre concerne uniquement la question de la fiscalité canadienne. Les placements d’une société résidente ne seraient pas touchés si le fait qu’ils sont effectués par la société résidente plutôt que par le non-résident pertinent se justifie par des motifs commerciaux. En toute autre circonstance, les placements seraient visés, sauf si aucun des principaux objectifs de l’opération ou de la série d’opérations en cause ne consiste à procurer un avantage fiscal «net» au groupe de sociétés pertinent.

- Les propositions devraient prévoir des exceptions pour les cas très clairs de certaines catégories de placements et de sociétés résidentes.

    - Les placements entièrement imposables ne devraient pas être visés, parce qu’ils demeurent dans l’assiette fiscale du Canada. D’ailleurs, on peut avancer que le but même de la retenue d’impôt est d’encourager les contribuables à maintenir les bénéfices dans l’assiette fiscale du Canada plutôt que de les distribuer. Ainsi, les prêts qui portent intérêt à un taux raisonnable (peut-être un taux prescrit) ne devraient pas être visés. Cela ne signifie pas qu’ils seraient exclus de l’application des règles sur les prix de transfert de l’article 247, ou d’autres règles applicables. Ils seraient simplement exclus de l’application de l’article proposé 212.3 et les conditions de ces prêts pourraient faire l'objet d’une vérification. En vue d’éviter une confusion des moyens, il faudrait envisager de modifier le paragraphe 15(2) de façon à permettre les prêts directs d’actionnaires et de sociétés sœurs consentis à des conditions raisonnables (comme le font les pays dont nous avons étudié le régime). Il serait alors nécessaire d'apporter des modifications correspondantes aux propositions du 19 août 2011 sur les prêts en amont.

    - De manière générale, les placements effectués dans le cadre de certains types de réorganisations ne devraient pas être visés.

    - Les sociétés résidentes cotées ou autres sociétés résidentes semblables (y compris les sociétés résidentes qui sont visées par les règles uniquement parce qu’elles sont contrôlées par une société non résidente qui est un élément de la structure d’un fonds de capital-investissement) ne devraient pas être visées.

    - Les sociétés résidentes qui ne possèdent aucun actif canadien important ne devraient pas être visées.

- Il faudrait éviter une imposition double ou démesurée.

- Lorsqu'il y a un dividende réputé mais qu'il n'y a pas de transfert de dette, les attributs fiscaux transfrontaliers de la société résidente pertinente devraient être ajustés.

- Le taux s'appliquant au dividende réputé devrait refléter le taux qui aurait été applicable si la société mère étrangère avait détenu directement les actions de la société résidente.

Enfin, nous tenons à souligner que, lors de la formulation de ces recommandations, nous n'avons pas tenté de refléter toutes leurs incidences possibles ou d'en parfaire le libellé suggéré au point de considérer qu'elles pourraient être mises en œuvre sans plus de considération. Au contraire, nos recommandations sont soumises à votre examen dans l'esprit d'entretenir un dialogue constructif en vue de l'élaboration de solutions qui pourraient être acceptables pour le plus grand nombre de parties prenantes.

Règles de capitalisation restreinte

Nos observations et nos recommandations concernant les règles de capitalisation restreinte sont davantage de nature technique.

Membres du sous-comité

Plusieurs membres du Comité mixte ont alimenté la réflexion ayant abouti à notre mémoire et ont participé à son élaboration, notamment :

Bill Brebber (Ernst & Young s.r.l. / S.E.N.C.R.L.)	K. A. Siobhan Monaghan (Davies Ward Phillips & Vineberg S.E.N.C.R.L., s.r.l.)	Mitch Sherman (Goodmans LLP)
Ron Durand (Stikeman Elliott S.E.N.C.R.L., s.r.l.)	Angelo Nikolakakis (Couzin Taylor s.r.l./s.e.n.c.r.l.)	Sandra Slaats (Deloitte & Touche LLP)
Gabe Hayos (ICCA)	Joel Nitikman (Fraser Milner Casgrain S.E.N.C.R.L.)	Jeffrey Trossman (Blake, Cassels & Graydon S.E.N.C.R.L., s.r.l.)
Darcy Moch (Bennett Jones LLP)	Janice Russell (PricewaterhouseCoopers s.r.l. / S.E.N.C.R.L.)	Penny Woolford (KPMG LLP)

Nous espérons que vous trouverez nos commentaires utiles et vous prions d'agréer, Monsieur, l'expression de nos sentiments distingués.

Penny Woolford
Présidente, Comité sur la fiscalité
L'Institut Canadien des Comptables Agréés

Darcy Moch
Président, Section de droit fiscal
L'Association du Barreau canadien

Submission of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants regarding the legislative proposals to amend the *Income Tax Act* (the "Act")[1] relating to international taxation (the "Legislative Proposals") contained in the federal Budget tabled on March 29, 2012 ("Budget Day", and the "Budget Plan")

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants is pleased to provide you with this submission on the Legislative Proposals.

We have divided our submission into two main components: the Legislative Proposals relating to what is referred to in the Budget Plan as "Foreign Affiliate Dumping" (the "FA Dumping Proposals"), and the Legislative Proposals relating to the "Thin Capitalization Rules" (the "Thin-Cap Proposals").

Part I – FA Dumping Proposals

1. Overall Policy Objectives

We begin our submission with a review of our understanding of certain contextual and tax policy considerations that are relevant in the context of the FA Dumping Proposals.

The Canadian Tax Base

As noted in the Budget Plan, while the Government "strongly supports cross-border trade and investment", it is important "to ensure that cross-border investment is not used as a tool to erode the corporate tax base". In principle, we agree with these views, and we believe we are on common ground that what is more important still is the strength and growth of the overall Canadian economy and tax base. For this reason, as noted in the Budget Plan, it is equally important to ensure "that *bona fide* business transactions are not affected".

The Joint Committee has consistently supported initiatives to improve the fairness, integrity and competitiveness of the Canadian income tax system both in general and in the cross-border context.

The Budget Plan refers to the report of the Advisory Panel on Canada's System of International Taxation (the "AP Report") in setting out a description of certain types of transactions involving foreign affiliates that are viewed as being "abusive" – those that "reduce the Canadian tax base without providing any significant economic benefit to Canadians". The Budget Plan also notes that the AP Report "recommended that a targeted measure be introduced to curtail these transactions while ensuring that *bona fide* business transactions are not affected". Here too, we agree in principle with these objectives. However, the principal challenge, as we see it, lies in

[1] Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the Act as proposed to be amended under the Legislative Proposals.

drawing the line between these two categories in a manner that does not produce significant unintended consequences, unfairness or uncertainty.

It is of course the Government's prerogative to establish and implement tax policy – including in relation to the treatment of domestic and cross-border investment. It is beyond our mandate to comment on matters of fundamental tax policy. That noted, we offer below certain observations based on our collective experience as professionals advising both private concerns and public institutions or governments on matters involving taxation. We also raise a number of more technical concerns we see with the FA Dumping Proposals.

Cross-Border Investment

Non-residents intersect with the Canadian income tax system in a variety of circumstances. The focus of our present discussion is on foreign-based multinational corporations. While Canada's treatment of, and attractiveness to, foreign individual portfolio investors, collective investment vehicles and other financial institutions are also very important, the focus of the FA Dumping Proposals is on circumstances in which there is a corporation resident in Canada (a "CRIC") that is controlled by non-resident corporation (a "Foreign Parent").[2]

A CRIC is the typical legal entity through which Foreign Parents make and hold direct investments in Canada. These investments represent a significant portion of Canada's economy. The corresponding portion of the Canadian tax base is thus reflected mainly by the corporate income tax ("CIT") payable by the CRIC on its taxable income, the withholding tax ("WHT") payable by the Foreign Parent on amounts paid or credited to it by the CRIC, and any CIT or WHT payable by the Foreign Parent on the disposition by it of an interest in the CRIC. The Budget Plan indicates that the FA Dumping Proposals are expected to raise approximately $1.3 billion over a 6-year period.[3] Presumably, this figure largely reflects an increase in the taxes expected to be paid by CRICs, although the Budget Plan does not explain the precise assumptions on which this figure is based.

In addition to carrying on a Canadian business, a CRIC may hold non-Canadian investments. Where a CRIC controlled by a Foreign Parent holds non-Canadian investments, it might be said, broadly speaking, that the Foreign Parent holds these non-Canadian investments *through* the CRIC. In significant measure, it is this view that seems to animate the FA Dumping Proposals, as the central rule in the proposals seeks to test whether or not the non-Canadian investments "belong" under the CRIC. Where this is determined to be the case, the FA Dumping Proposals have no impact. In any other case, the FA Dumping Proposals would apply to any kind of investment in a foreign affiliate made on or after Budget Day – even follow-on investments in previously-held foreign affiliates, and even investments that yield taxable income at reasonable rates or do not otherwise erode the Canadian tax base. Where applicable, the FA Dumping Proposals give rise either to the elimination of any paid-up capital ("PUC")[4] otherwise resulting

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[2] We do nevertheless comment below on certain aspects of the FA Dumping Proposals that affect the treatment of public corporations and private equity funds.

[3] See at page 381. That represents approximately 0.08% of total budgetary revenues over the same period.

[4] And any contributed surplus may be excluded from equity for purposes of the thin-capitalization rules in subsection 18(4), and excluded from conversion to PUC under the rules in subsection 84(1).

from the acquisition by the CRIC of the non-Canadian investments, or to a dividend deemed to have been paid by the CRIC to the Foreign Parent.

The usual treatment to a CRIC of making or holding non-Canadian investments is well known and will not be discussed here in detail. However, we observe that CRICs continue to be taxable in Canada under the CIT on income and gains in respect of non-Canadian investments with the exception of actual or deemed dividends from a foreign affiliate that are considered to have been paid out of "exempt surplus". A Foreign Parent also continues to be subject to Canadian WHT in respect of dividends from a CRIC – including those funded out of "exempt surplus" dividends received by the CRIC from a foreign affiliate.

The Legislative Proposals do not state whether the Government has made any decision with respect to the recommendations in the AP Report that these features of our international tax system be modified – to expand the exemption system and possibly reduce or eliminate the WHT on dividends.[5] As a result, unless further changes are made to give effect to these recommendations, Canada will continue taxing the CRIC in respect of non-Canadian investments that, under the FA Dumping Proposals, are not considered to "belong" under the CRIC. In that sense, Canada will effectively be taxing what it views as the non-Canadian income of a Foreign Parent, simply because it passes through a CRIC, and yet the FA Dumping Proposals will nevertheless treat the CRIC as having distributed the non-Canadian investments to the Foreign Parent by deeming a dividend to arise.

The cumulative effect of these developments raises a concern, in that they seem to be internally inconsistent, and inconsistent directionally with the approach that other countries are taking in reforming their international taxation systems. We are particularly concerned that this approach may tend to undermine the perception of the fairness and competitiveness of Canada's income tax system among foreign jurisdictions and foreign-based multinational corporations. In our experience, the relative fairness and competitiveness of income tax systems are judged not only with reference to the "headline" rates imposed by different jurisdictions, but also by the scope, structure and coherence of their anti-avoidance rules, and their approach to tax administration. From that perspective, and more generally, we encourage the Government to balance the introduction of the FA Dumping Proposals with the introduction of broader changes to the international tax system, or at least targeted ones applicable only to investments affected by the FA Dumping Proposals.

The stated purpose of the FA Dumping Proposals is to "curtail" transactions that "reduce the Canadian tax base without providing any significant economic benefit to Canadians"; however, "bona fide business transactions" are not intended to be affected. We appreciate that it is inherently difficult to measure "economic benefit to Canadians". However, the scope of the FA Dumping Proposals suggests an underlying premise that very few, if any, non-Canadian investments made or held by a CRIC controlled by a Foreign Parent would provide any significant economic benefit to Canadians. We do not share this perspective.

We believe there are many cases where such investments provide net economic benefits to Canada. Thus, we believe the design of the FA Dumping Proposals should place greater emphasis

[5] Obviously, however, the elimination of dividend WHT would require revisions to any measures adopted along the lines of the FA Dumping Proposals, because of their deemed dividend approach.

on the question of whether the circumstances surrounding the investment are such as may reasonably be considered to result in material erosion of the Canadian tax base. In our view, the FA Dumping Proposals should not block transactions that may be driven primarily by foreign business and tax considerations, where none of the main purposes of the relevant transactions may reasonably be considered to be to achieve a material erosion of the Canadian tax base. By targeting only transactions that materially erode the Canadian tax base, we believe the likelihood of unintended consequences is minimized. We also believe a more targeted approach would be much better understood internationally.

We are not economists, so we are not in a position to comment on the broader economic implications of the FA Dumping Proposals. However, we observe that various substantive and administrative aspects of our income tax system have long been premised on the notion that taxpayers and the Crown do have the ability to determine whether particular transactions or series of transactions can reasonably be considered to be "bona fide business transactions" and/or to "reduce the Canadian tax base". These are judgments that can be difficult to make in particular circumstances, but we and our courts are accustomed to making them. We also observe that various aspects of our income tax system have long been premised on the more specific notion that taxpayers and the Crown do have the ability to determine the fair market value of property and arm's length terms and conditions. These, too, can be difficult judgments. But such judgments are unavoidable, and considerable guidance exists to ensure more generally the protection of the Canadian tax base from manipulative dealings.

Finally, we note that CRICs controlled by Foreign Parents also raise and deploy significant amounts of equity and debt capital. Such CRICs may access Canadian debt capital markets (whether through syndicated or other bank loans or through the issuance of debt securities) and use the proceeds to make various kinds of investments, including *bona fide* interest-bearing loans to the Foreign Parent or to other members of the corporate group on arm's length terms.[6] It is difficult for us to see why these arrangements should be considered to reduce the Canadian tax base. Moreover, we believe that such arrangements do provide significant economic benefits to Canadians, in that they tend to support the depth and strength of Canadian debt capital markets and financial institutions. Similarly, where a CRIC controlled by a Foreign Parent uses excess cash on hand to make interest-bearing loans to the Foreign Parent or other members of the corporate group on arm's length terms, it is difficult for us to see why the arrangements should be considered to reduce the Canadian tax base. While the funds may not be deployed in Canadian operations, they remain within the Canadian tax base in every respect. Indeed, if such funds remain within the Canadian tax base for a long enough period of time (depending on prevailing interest rates), then more tax revenues would be raised than if the funds are distributed to the Foreign Parent, producing a one-time levy of WHT.[7] Indeed, it can be argued that the very purpose of the WHT is to encourage taxpayers to retain profits within the Canadian tax base rather than distributing them. In addition, the retention and redeployment, rather than the distribution, of such funds by CRICs would tend to support the strength of their balance sheets, which may have salutary effects on their cost of capital more generally or even their solvency at

[6] We also note that a CRIC that borrows money generally cannot distribute that money in excess of the amount by which the realizable value of its assets exceeds the aggregate of its liabilities and the stated capital of all classes of shares – because of corporate solvency restrictions in Canadian corporate legislation.

[7] A 5% interest rate subjected to CIT at 25% would recoup more than the 5% WHT after the fourth year.

times of financial turbulence or crisis, and thereby also translate into significant economic benefit to Canadians.

General Recommendations

Accordingly, in order to balance these considerations, we submit that the FA Dumping Proposals should be crafted so as not to:

- affect transactions and arrangements that do not erode the Canadian tax base,

- impose tax costs that are duplicative or disproportionate to the resulting tax benefits,

- introduce inordinate uncertainty and administrative or compliance costs, or

- detract from the actual or perceived competitiveness of the Canadian income tax system.

In brief, we submit that these measures should be tailored and balanced, and should not undermine the fairness, coherence and competitiveness of the Canadian income tax system or unduly compromise the attractiveness to foreign-based multinational corporations of making or holding investments, or raising or deploying capital, in or through Canada. Our more specific recommendations below are informed by this perspective.

2. Business Purpose Exception, Factors and Covered Investments

The BPE as drafted

The "business purpose exception" (the "BPE") in paragraph 212.3(1)(c) provides that the FA Dumping rules in subsection 212.3(2) do not apply to an investment in a subject corporation (an "SC") that is made, at any time, by a CRIC that is controlled by a Foreign Parent if:

> (c) the investment may not reasonably be considered to have been made by the CRIC, instead of being made or retained by the parent or another non-resident person that does not deal at arm's length with the parent, primarily for *bona fide* purposes other than to obtain a tax benefit (as defined in subsection 245(1)).

In determining whether the BPE is met, the factors set out in subsection 212.3(5) are to be given "primary consideration". Other unspecified factors may be relevant but they are not to be given "primary consideration".

Alignment of BPE with Government's Policy Objectives

The factors in subsection 212.3(5) describe exclusively non-tax considerations that effectively require a taxpayer to establish that there is a stronger business case for the investment to have been made by the CRIC than by any other non-arm's length, non-resident person. We understand that the BPE is intended to apply only where it can be demonstrated, having regard to the enumerated factors, that the investment in the SC truly "belongs" in the CRIC to a demonstrably *greater* extent than it "belongs" in any other non-resident member of the Foreign Parent's corporate group. The factors also place considerable emphasis on the location and other aspects of the management structure of the Foreign Parent, the CRIC and the SC.

Given the Government's overall tax policy objective to "curtail" transactions that "reduce the Canadian tax base without providing any significant economic benefit to Canadians", but without affecting "bona fide business transactions", we submit that it would be more appropriate to frame the BPE as an inquiry into whether the investment in the SC by a CRIC with a Foreign Parent erodes the Canadian tax base without a sufficient commercial justification. The measure ought to target transactions (and series of transactions) that lack business purpose <u>and</u> result in a "net deduction" from Canadian-source income or the creation of paid-up capital in shares of a CRIC to increase thin-capitalization thresholds or to facilitate "surplus stripping" free of the WHT. Viewed in this light, we respectfully submit that the BPE as currently drafted does not properly distinguish between investments that offend the Government's policy objectives and those that do not.

We recognize that the Department of Finance ("Finance") has publicly stated that the "best business case" approach reflected in the FA Dumping Proposals was adopted consciously and deliberately, and consequently there may be reluctance to adopt a different construct. Nonetheless, as noted above, it is our view that this approach is not the most appropriate for distinguishing those investments which offend the Government's policy objectives from those that ought to be considered acceptable.

The "best business case" approach, particularly when combined with the "factors" identified in subsection 212.3(5), may be under-inclusive in some cases, and would be over-inclusive in other cases. On the under-inclusive side, for example, a Foreign Parent seeking a significant Canadian tax benefit may conclude that the costs of restructuring and migrating relevant senior management functions into Canada, and changing reporting lines and compensation schemes, are relatively insignificant when compared with the potential tax benefits of making a large and leveraged non-Canadian investment through a CRIC.

On the other hand, investments funded with a CRIC's tax-paid retained earnings or that can be traced to Foreign Parent contributions, and investments that yield taxable income to the CRIC, which thus have no direct adverse consequences on the CIT base, are not generally excepted, notwithstanding that it is not at all apparent that such transactions are within the policy objectives intended to be advanced by the FA Dumping Proposals.

Indeed, the presence or absence of a tax benefit appears to not even be a "factor" to be given "primary consideration" in determining whether the BPE applies.

Notwithstanding that the measure does not necessarily affect all non-Canadian investments by CRICs controlled by Foreign Parents, we believe there is a material risk that, by virtue of the breadth and potentially punitive nature of the proposed approach, investors may draw adverse conclusions regarding the receptiveness of Canada to foreign investment generally. As noted above, it is also our view that this potential for over-inclusiveness could unnecessarily discourage transactions that may not reasonably be considered to result in any material reduction of the Canadian tax base, and thus we are concerned that the measure itself could ultimately have the undesirable and unintended effect of eroding the Canadian economy and tax base.

We believe a more targeted rule, focused explicitly on specified types of tax avoidance, would be better aligned with the Government's policy objectives and better understood internationally, and thus less likely to be perceived or to operate as a tax increase on foreign investors or otherwise be inconsistent with the Government's "strong support" of cross-border trade and investment either in Canada or in relation to the use of a CRIC as a holding company for international investments and similar arrangements.

We are also very conscious of Finance's comments regarding the potential hazards of adopting a rule that targets only debt-financed investments, including the possibility of taxpayers adopting cash damming and similar techniques to indirectly achieve base-eroding benefits. We also understand and share Finance's desire to avoid the complexity associated with the introduction of statutory tracing and similar rules.

However, we believe a better balance can be struck by re-orienting the BPE so that it includes a second prong that focuses on the presence or absence of a specified tax benefit as a direct or indirect result of the series of transactions that includes the investment. We believe that such a re-oriented rule, which could still incorporate enumerated factors, in a revised subsection 212.3(5), would more appropriately distinguish between acceptable and unacceptable transactions.

Factors – Commercial and Economic Reality

In our experience, the currently enumerated factors do not align with the manner in which multinational corporate groups normally structure their management, reporting and compensation arrangements. These arrangements tend to be focused more on divisional considerations.

Paragraph 212.3(5)(c) essentially asks whether the investment was made at the direction or request of the Foreign Parent. Paragraphs 212.3(5)(d) to (g) ask whether certain tasks and responsibilities are borne by, and compensation inures to, senior officers of the CRIC.

Whether the factors in paragraphs 212.2(5)(c) to (g) are met may depend on the internal management organization of the Foreign Parent group. A Foreign Parent group may adopt a functional business organization to achieve economies of scale or other business objectives. Under a functional business organization, each of the Foreign Parent, the CRIC, and every member of the corporate group may share the same personnel responsible for negotiating, making and managing investments. Management reporting lines and decision-making authority are often not divided neatly between separate legal entities. There will be at least some overlap of management reporting obligations of the officers of the CRIC and those of the ultimate Foreign Parent (or, at a minimum, those of its direct foreign shareholder). The compensation policy for personnel across the enterprise may be based on the performance of a functional business unit, rather than the performance of a legal entity.

Further, each of paragraphs 212.3(5)(d) to (g) refers to "senior officers of the CRIC *who were resident in, and working principally in, Canada*." While it is always desirable to promote employment in Canada, such a standard does not appear to us to be consistent with the commercial and economic considerations that are relevant in determining the management structure of a foreign or Canadian multinational enterprise.

We submit that the management structure of the Foreign Parent and related entities should not be primary factors in determining whether the investment is inconsistent with Canadian tax policy objectives.

Factors – Uncertainty

Subsection 212.3(5) sets out factors to be given "primary consideration" in determining whether the BPE in paragraph 212.3(1)(c) applies. However, there is no guidance as to how the various factors are to be weighed. Some factors are phrased in the negative, while others are phrased in the positive. It is unclear whether meeting a negative factor results in failure of the BPE, or how many positive factors must be present to meet the BPE. Further, there is no guidance in the legislation as to factors deserving of secondary consideration.

Many of these factors also involve factual considerations in relation to which there is simply no experience or reliable standard under the principles and practices that are relevant in the context of applying and administering the Act, and no further legislative guidance is provided under the FA Dumping Proposals. For example, it is unclear how to determine whether or not a particular investment is "more closely connected to the business activities carried on by the CRIC", or whether a particular corporate officer is "senior".[8] While we appreciate further guidance may be forthcoming in the explanatory notes, we question the appropriateness of using vague and novel terms in the legislation, and believe a better approach is to tie the rule to more conventional constructs typically found in specific anti-avoidance rules.

In many cases, it will not be feasible, because of time constraints, to obtain an advance income tax ruling on point, and it is unclear whether the Canada Revenue Agency (the "CRA") would even be prepared or able to rule on the types of factual considerations that are referred to in subsection 212.3(5). The resulting inherent and unavoidable uncertainty will tend to discourage any investment in or through Canada by Foreign Parents, and would be inconsistent with the goal of promoting predictability of commercial and financial arrangements and their financial statement presentation.

Investment Definition

The term "investment" is defined very broadly in subsection 212.3(3). It is the acquisition of any such investment that must be tested under the BPE.

The AP Report focused primarily on an investment in preferred shares for which the dividends would be fully exempt from Canadian tax. However, in many cases, the CRIC could be investing in shares of a corporation that is or becomes a foreign affiliate of the CRIC without any prospect of receiving dividends that are fully exempt from tax, or making an investment that will result in future capital gains that will be subject to tax in Canada. An investment in a SC may also give rise

[8] The meaning of the term "officer" is well understood by reference to the relevant corporate law. It connotes a person appointed by the board of directors to manage the business or affairs of the corporation. However, there is no well accepted definition of a "senior" officer. A senior officer cannot necessarily be identified by title, as terminology varies across industries and legal entities. We submit that the lack of a statutory definition of "senior officer" creates uncertainty and may narrow the ambit of the BPE because qualified personnel of the CRIC may perform the tasks and responsibilities described in the factors but may lack sufficient seniority to qualify as "senior" officers.

to current taxation under the Act because of the attribution of "foreign accrual property income" ("FAPI"), or the application of section 17. Ultimately, the return on an investment in these circumstances may generate more Canadian tax than would have existed if that investment had not been made, even where it generates "exempt surplus" dividends.

Many multinationals use centralized cash management processes to manage the temporary redeployment of cash. These arrangements may result in "sweeping" the cash into the bank account of one legal entity temporarily until such time as the balance is periodically settled. This process could result in an amount shifting from an amount temporarily owed to the CRIC to an amount owing by the CRIC. Thus, the mere acquisition of such an investment by a CRIC that is controlled by a Foreign Parent should not result in an immediate adverse tax consequence. This seems to be acknowledged by the Legislative Proposals overall, in that they do not feature any measure to eliminate the 2-year grace period that applies under subsection 15(2).

Paragraph 212.3(3)(f) refers to "any transaction or event that is similar in effect to any of the transactions described in (a) to (e)". This novel language creates considerable, and in our view, excessive uncertainty. It is unclear to us why the definition of investment should include anything other than an acquisition of shares of a SC, or indebtedness that has uncommercial terms.

Main Recommendations

In light of the views we have expressed above, we submit that consideration should be given to re-orienting the BPE in paragraph 212.3(1)(c), the definition of covered investments in subsection 212.3(3), and the factors in subsection 212.3(5).

BPE

We submit that paragraph 212.3(1)(c) should be revised to provide that subsection 212.3(2) does not apply where:

> (c) it may reasonably be considered that
>
> > (i) based on all considerations (other than Canadian or foreign tax considerations) relevant to the CRIC and all specified persons, it is more desirable for the investment to be made by the CRIC, instead of the CRIC or a specified person completing an alternative transaction, or
> >
> > (ii) none of the main purposes of the investment, or, where the investment is made by the CRIC in the course of a series of transactions or events, none of the main purposes of the series of transactions or events, is to obtain a specified tax benefit within the group consisting of the CRIC and every specified person.

For these purposes, we submit that a number of tailored definitions would be useful, including a definition of "specified tax benefit". These definitions would be aligned with the Government's stated policy objectives and, in particular, would be targeted to circumstances involving either "debt dumping" or "surplus stripping". The design of the definitions would specifically take into account the Government's desire to avoid an overly narrow rule that can easily be circumvented through cash damming and similar techniques. We believe that the "series of transactions" concept, which has been very broadly construed by our courts, should achieve that objective.

The "specified tax benefit" definition should focus on the concept of a "net" tax benefit, thus ensuring that full account is taken of both any tax reduction and any tax increase arising from the investment or overall series of transactions.[9] Thus, in determining whether it may reasonably be considered that a main purpose is to obtain a "specified tax benefit", it would be necessary to take into account not only any increased deductible expenses (such as interest deductions) but also any increased taxable income and withholding tax equivalents that may reasonably be considered to arise as a result of the relevant series of transactions. In order to assess whether a net tax benefit arises, it would be necessary to compare the Canadian tax consequences to all specified persons of reasonably feasible alternative transactions, and we believe it would be helpful to specifically define the concept of "alternative transaction" for this purpose, so there is no misunderstanding of the benchmark against which the tax consequences of the investment are being compared.

This two-pronged approach to the BPE, with the support of an appropriate definition of "specified tax benefit", is intended to balance the Government's "strong support" for cross-border trade and investment with the Government's objective of ensuring that cross-border investment is not used as a "tool to erode the corporate tax base".

In particular, we offer for your consideration the following illustrative definitions:

> "alternative transaction" in relation to a particular subject investment made by a CRIC means every transaction and every series of transactions or events that may reasonably be considered to constitute a feasible alternative to the subject investment from the perspective of the CRIC and all specified persons, which is commercially equivalent in all material respects to the subject investment, and shall include each of the following:
>
> (a) in any case where the consideration for the subject investment includes property other than shares in the capital stock of the CRIC or of a specified resident, the payment of a dividend by the CRIC or a specified resident,
>
> (b) the subject investment being made or retained by any specified non-resident, and
>
> (c) the subject investment not being made by any person.
>
> "specified non-resident" in relation to a CRIC means the parent in relation to the CRIC and every non-resident person that does not deal at arm's length with the

[9] The jurisprudence under section 245 is not clear because it may be argued that in some cases a "tax benefit" may be considered to exist with reference only to a deduction available for interest expense, without looking at the taxable income component (*Canada Trustco*, paragraph 20). That may not be a significant concern under section 245 because of subsection 245(4) and because subsection 245(2) directs a reassessment tailored to achieve the tax consequences that are "reasonable in the circumstances". In contrast, where section 212.3 applies, there is neither a "no abuse" escape valve nor any flexibility around the resulting tax treatment.

parent (otherwise than because of paragraph 251(5)(b) of the Act).

"specified resident" in relation to a CRIC means a person (other than the CRIC) that is resident in Canada and that does not deal at arm's length with the parent (otherwise than because of paragraph 251(5)(b) of the Act).

"specified person" in relation to a CRIC means every specified non-resident and specified resident in relation to the CRIC.

"specified tax benefit" – the amount of a specified tax benefit that shall be considered to result from a subject investment made by a CRIC, or from a series of transactions or events that includes the subject investment (in this definition referred to as a "series"), as the case may be, shall be the amount, if any, by which

> (a) the total of all amounts each of which may reasonably be considered to be the amount of a reduction, avoidance or deferral of tax or other amount payable under this Act by the CRIC or a specified person, or the amount of an increase in a refund of tax or other amount payable under this Act to the CRIC or a specified person, resulting from the subject investment or series, as the case may be,

exceeds

> (b) the total of all amounts each of which may reasonably be considered to be the amount of an increase or acceleration of tax or other amount payable under this Act by the CRIC or a specified person, or the amount of a reduction in a refund of tax or other amount payable under this Act to the CRIC or a specified person, resulting from the subject investment or series, as the case may be,

provided that the tax consequences arising from the subject investment or series, as the case may be, shall in each case be compared to the tax consequences of each alternative transaction in respect of the subject investment,

"subject investment" means a particular investment in a subject corporation made by a particular CRIC at a particular time.

"tax consequences" and "transaction" have the respective meanings attributed to those terms in section 245.

With reference to investments funded with cash generated from the CRIC's (or a non-arm's length CRIC's) Canadian business operations, the determinations described above would be expected to operate to allow only investments (compared to the alternative of paying dividends), that are made based purely on non-tax considerations, or where the CIT payable by the CRIC because of the taxable income resulting to the CRIC from the investment over some reasonable period is reasonably expected to at least equal the WHT that would instead be payable by the Foreign Parent on the payment of a dividend by the CRIC.

To simplify both the "debt dumping" and "surplus stripping" aspects of the rules, we further recommend, as described below, that a "bright line" exception be provided for certain categories of investments – essentially, those that yield an acceptable amount of taxable income. Our proposal, as noted below, is that this bright-line exception be implemented by carving these types of investments out of the definition of an "investment".

Investments

We submit that subsection 212.3(3) should be revised to read as follows:

> (3) For the purposes of this section, an investment made in a subject corporation by a CRIC means any of
>
> (a) an acquisition of shares of the capital stock of the subject corporation by the CRIC, other than shares in respect of which it may reasonably be expected that the amount that will be included in computing the income of the CRIC (net of any deduction in respect of that amount that may be made in computing the income of the CRIC under section 91 or in computing the taxable income of the CRIC under section 113), for each taxation year or portion thereof during which the shares are held by the CRIC, is not less than the amount of interest that would have accrued on a principal amount equal to the amount of the consideration given for the investment computed at the rate of interest [prescribed for purposes of subsection 80.4(2)]; or
>
> (b) a transaction under which an amount became owing by the subject corporation to the CRIC, other than
>
> > (i) an amount owing or that arose or was acquired in the ordinary course of the business of the CRIC and that was repaid within a commercially reasonable period; and
> >
> > (ii) an amount owing in respect of which it may reasonably be expected that the amount that will be included in computing the income of the CRIC, for each taxation year or portion thereof during which the amount is owing to the CRIC, is not less than the amount of interest that would have accrued on a principal amount equal to the amount of the consideration given for the investment computed at the rate of interest [prescribed for purposes of subsection 80.4(2)].

For these purposes, we submit that special supporting rules should be developed to address any circumstances in which equivalent treatment should arise in respect of contributions of capital and the acquisition of options. Capital contributions may be equivalent to share acquisitions where the CRIC already holds shares of the SC, but they also may already give rise to deemed dividends because of the application of subsection 15(1) to the extent that a value shift occurs. It is our view, more generally, that section 212.3 should not apply to a transaction to the extent that the transaction already gives rise to a deemed dividend or PUC reduction pursuant to the application of other provisions of the Act. This issue is discussed below in greater detail.

Factors

In connection with our recommended re-orientation of the BPE, we recommend that a modified list of primary factors be included in subsection 212.3(5), directed only at the "specified tax benefit" analysis, such that a revised version of this rule could be as follows (with perhaps some additional factors):

> (5) In applying subparagraph (1)(c)(ii), all relevant factors must be considered, including the following factors:
>
> (a) whether, as part of the series of transactions that includes the investment, if any, the CRIC or a specified resident incurs any interest-bearing indebtedness the proceeds of which are used, directly or indirectly, by the CRIC or a specified resident for the purpose of making the investment, or for the purpose of funding outlays or expenses that do not relate to making the investment where the indebtedness is incurred by the CRIC or a specified resident in contemplation of the accumulation of revenues by the CRIC or a specified resident to be used or that were used for the purpose of making the investment;
>
> (b) the amount, rate and timing of any taxes payable under Part XIII by any specified non-resident in respect of any indebtedness referred to in paragraph (a); and
>
> (c) whether the investment was disposed of or issued to the CRIC by a person that, immediately before consummation of the investment, was a specified non-resident.

Further Comments on Factors

A CRIC may use surplus cash derived from its business operations or investments to make a debt or equity investment in an existing foreign affiliate. This kind of transaction may arise for a number of reasons that have nothing to do with "foreign affiliate dumping" but which nonetheless could be subject to section 212.3 as currently drafted.

Some of these CRICs will be former Canadian-based multinational corporations that were acquired by a Foreign Parent and which have retained interests in the foreign affiliates they held at the time of their acquisition. It is not always possible for such foreign affiliates to be extracted from the CRIC either because of prohibitive Canadian or foreign tax considerations, or because of commercial considerations such as the covenants of the CRIC or other relevant entities.[10] Other CRICs will hold shares of a foreign affiliate where unrelated parties also hold shares of the affiliate, such as where a CRIC and one or more other parties carry on joint venture activities through a foreign corporation or where a CRIC has made foreign investments on a consortium basis with other investors.

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[10] Canadian tax considerations would be mitigated considerably by an expansion of the exemption system (or even just an expansion of the "bump" rule under paragraph 88(1)(d) to permit shares of a Foreign Parent to be "specified property" in appropriate circumstances), and a reduction or elimination of dividend WHT, as recommended in the AP Report.

There are several reasons why a CRIC might choose to invest surplus cash in an existing foreign affiliate, including contractual or other on-going requirements to provide funding for the foreign affiliate's business activities. Where a CRIC with excess cash has a foreign affiliate in need of funding, it will often make the most sense for the CRIC to provide that funding rather than another corporation within the multinational group to keep the overall corporate structure as simple as possible. This decision may have nothing to do with tax. Moreover, in some cases, a CRIC will retain and invest its surplus cash instead of distributing it to its foreign parent in order to minimize foreign taxes, such as those that would be paid by a U.S. parent on a CRIC dividend.

This is a context in which it is very difficult to conceive of rules and factors that would be sensitive enough to properly distinguish between cases reflecting Canadian tax avoidance *versus bona fide* business transactions. Nevertheless, it seems clear that such transactions should not be affected if done purely for non-tax reasons or where they are done in a way that does not erode the Canadian tax base because they generate sufficient taxable income. Where the matter is less clear is where there is a mixture of tax and non-tax considerations driving the investment to be made in a way that yields a reasonable economic return that nevertheless yields a lower amount of taxable income. While we have endeavored to construct a BPE that draws an appropriate line, and one that we believe effectively targets the concern at which the measure is addressed, we believe that this is an extraordinarily difficult exercise, and suggest that in order to ensure the rule works as expected, further consultation and study is warranted.

3. Circumstances Involving Special Considerations

A. CRICs with no material Canadian assets

Background

CRICs are sometimes established as holding corporations for investment in foreign corporations, but may themselves have little or no Canadian-source income. These CRICs may be private or public. Canada is frequently viewed as a desirable jurisdiction through which to hold foreign assets because it is stable, has expertise in particular industries (such as natural resources), has robust capital markets, and has well-understood laws that are generally similar to those in other common law jurisdictions. The exemption system reflected in Canada's foreign affiliate rules is in many instances viewed as tantamount to a European style participation exemption regime, at least with respect to active business income earned in a treaty or TIEA country. In addition, while Canada generally taxes capital gains on dispositions of shares of foreign affiliates (to the extent those gains exceed undistributed tax-free surplus balances), this factor may be discounted where no sale of the foreign affiliate shares at the level of the CRIC is contemplated in the foreseeable future. Overall, therefore, Canada is a desirable holding jurisdiction, although further measures could be introduced to improve Canada's attractiveness in this regard, as recommended in the AP Report.

Often a holding corporation is established in Canada to provide access to Canadian capital markets. Listing of shares on a Canadian stock market enables the issuer to access well-developed equity markets with particular knowledge in certain sectors such as natural resources, while at the same time providing Canadian investors with a broader opportunity to invest in securities of businesses with little connection to Canada. The holding of foreign affiliates by such corporations results in no material erosion of the Canadian tax base because the holding corporations typically have little or no Canadian source income . While the establishment of the Canadian holding company in these circumstances is not tax-motivated, applying the factors in subsection 212.3(5) could result in the conclusion that the rules will apply in a wide variety of cases, because:

(a) the holding CRIC is unlikely to have business activities in Canada;

(b) assuming the SC is a wholly-owned or majority-owned subsidiary, this factor is not applicable (or is neutral at best);

(c) the holding CRIC may have been established specifically for the purpose of acquiring the foreign assets at the controlling shareholder's direction; and

(d) to (g) a majority of the CRIC's directors and its management, as well as the management of the SC, may be outside Canada, because there are no meaningful activities in Canada.

This type of arrangement is not "used as a tool to erode the corporate tax base". Furthermore, these structures benefit Canada by increasing demand for Canadian expertise in such diverse areas as financial, legal and accounting advice, industry expertise, bank financing, and, in the case of public companies, by generating listing fees and generally furthering the credibility and reputation of Canadian equity markets.

Recommendation

As pure holding companies do not erode the Canadian tax base, and do generate benefits for Canada that seem to be significant, we recommend that there should be an exception from section 212.3 for any investment made by a CRIC if all or substantially all of the property of the CRIC consists of property other than "Canadian property" throughout the taxation year. Canadian property would include assets used in the course of a business carried on in Canada or to earn income from property that is itself a Canadian property but would exclude investments in foreign affiliates, foreign trusts and partnerships which, in each case, have no more than a *de minimis* amount of Canadian source income. Canadian property would exclude shares, debt or other interests in CRICs, Canadian trusts or Canadian partnerships none of the property of which is Canadian property. Temporary cash balances held for investment in non-Canadian property within a specified period of time would be deemed to be non-Canadian property.

While we recognize there may be some modest definitional complexity associated with such an exception, we believe the exception would provide overall benefits to all stakeholders by better targeting the measure at the policy objectives it is intended to address.

We also acknowledge that consideration would need to be given to the proper treatment of any tax attributes of a CRIC which benefits from this exception in the context of a subsequent acquisition of the control of the CRIC or its merger or other combination with another CRIC.

B. CRICs with common shares listed on a designated stock exchange in Canada

Background

We believe that special considerations apply in the context of public companies. The premise of the FA Dumping Proposals is that the Foreign Parent has the capacity to cause the CRIC to invest in SCs. However, any CRIC which is a reporting issuer under Canadian securities laws is subject to numerous checks which significantly mitigate the controlling shareholder's ability to manipulate matters to its benefit.

As in the case of non-public CRICs, the board of directors of a public CRIC is required to manage (or supervise the management of) the corporation's business and affairs, and has a duty to act honestly and in good faith with a view to the best interests of the corporation. Thus, the board has a fiduciary obligation to act in the best interests of the corporation. It may not prefer the interests of the shareholders or a particular shareholder (even a sole shareholder) over the interests of the corporation. While the same might be said of all corporations, the controlling shareholder's influence in a publicly-listed corporation is further diminished by the requirement that all public corporations have independent directors. While we recognize that a foreign controlling shareholder of a public CRIC may have considerable influence over the board, the presence of independent directors provides a check on that influence.

Further, under Canadian securities laws, certain transactions between the CRIC and its controlling shareholder or other corporations controlled by its controlling shareholder will require an independent valuation and minority shareholder approval. Moreover, while there is no formal requirement that the board appoint a "special committee" of independent directors to consider the fairness or appropriateness of a related-party transaction, there is a requirement to publicly disclose whether the corporation has appointed such a committee and, because good corporate governance practice would mandate a special committee, it is typical for special committees to be appointed for any material transaction between the controller and the public company. Special committees by definition must evaluate the transaction from the sole standpoint of the public company without considering the collateral benefits the controller may derive from the transaction.

Where such a CRIC acquires an investment in a SC, whether from an arm's length person or another corporation to which it is related, consideration of the factors in subsection 212.3(5) generally will not permit one to conclude comfortably that the rules do not apply.

Furthermore, if the CRIC is owned as to, say, 51%, by the Foreign Parent, the BPE as articulated in paragraph 212.3(1)(c) is exceedingly difficult, if not impossible to apply on any rational basis. The test presupposes that the acquisition of the investment by the Foreign Parent is a reasonable alternative to acquisition of the investment by the CRIC. Yet, unlike the situation of a multinational enterprise with a wholly-owned Canadian subsidiary, the two alternatives are inherently different transactions. One involves the Foreign Parent acquiring 100% of the investment; the other involves an indirect acquisition of only 51%. Clearly, this is a comparison of "apples" and "oranges", and it is extremely difficult to see how a taxpayer, the CRA or a court could rationally apply the test, which seems to have been devised with a very different fact pattern in mind (i.e., a wholly-owned or otherwise closely-held CRIC).

More generally, we are concerned that the FA Dumping Proposals will tend to discourage *bona fide* business transactions by public CRICs, thereby effectively reducing the opportunities for Canadian investors to participate in such foreign investments.

Recommendation

For all of these reasons, we recommend the following:

(a) A presumptive exception from section 212.3 for a CRIC the common shares of which are listed on a designated stock exchange in Canada; and

(b) in order to deter "listings of convenience", a specific anti-avoidance rule under which the exception would be denied where it is reasonable to consider that the primary purpose of the listing was to qualify for the exception.

We believe this carve-out would more appropriately limit the application of the measure to situations where the underlying premise of the measure – that the Foreign Parent can cause the CRIC to do whatever it chooses to cause it to do – is more likely to be accurate. We recognize that this exception leaves out other minority ownership situations, where there may also be real checks on the Foreign Parent's ability to influence the CRIC, but we believe a rational distinction can be made based on the special protective features of Canadian securities laws which are engaged only in a public company situation, as well as the greater need for certainty for entities with securities trading in Canadian capital markets.

C. Private Equity Funds

Background

We believe that in designing the FA Dumping Proposals, the impact of the measure on CRICs in which private equity funds have invested (or may in the future invest) should be specifically considered.

Over the past decade, private equity funds have become an increasingly important source of liquidity for Canadian businesses. Funds have assumed ownership, and sometimes controlling, positions in a wide range of Canadian public and private companies. Their investments have played a key role in the restructuring or sale of both healthy and struggling businesses in virtually all sectors of the Canadian economy.

In practice, private equity funds come in all shapes and sizes. Most are managed from outside Canada. Some funds (commonly called "venture capital" funds) focus on early stage companies that typically need funding to pursue or commercialize scientific and other research or concepts, but are often generating little or no cash flow, and may not qualify for traditional forms of financing. Other funds focus on opportunities to create value for their investors by acquiring controlling positions in companies perceived to be under-performing. Such acquisitions are frequently followed by significant changes in management. Investors in these funds often include significant institutional investors, including public or private pension funds and sovereign investors, as well as investors from the private wealth sector.

While private equity funds are typically organized as limited partnerships, it is common for such funds to use intermediate holding companies (often US LLCs or Luxembourg holding companies) to accommodate co-investments in a particular portfolio investment and for other structuring reasons.

Private equity funds are an important source of future foreign investment in Canada. Such investors are, by their nature, "financial", rather than "strategic" investors. They often have a long range plan to "exit" within a specified period of time, hoping to realize gains from their re-structuring efforts. Such investors typically think globally, constantly assessing the extent to which various jurisdictions welcome foreign investment.

We are concerned that, unless the scope of the measure is clarified, there is a material risk that such funds will draw an adverse inference about the Canadian government's general attitude towards foreign investment.

Application of FA Dumping Rule to Private Equity Funds

We question whether it is truly appropriate to treat CRICs controlled by a private equity fund in the same way as Canadian subsidiaries of Foreign Parents. While we recognize that a line must be drawn somewhere, and acknowledge that the decision was made to apply the FA Dumping Proposals to CRICs controlled by non-resident corporations, private equity funds investing in Canada may need to manage the potential impact of the FA Dumping Proposals by altering their normal structures (for example) by eliminating intermediate holding companies inserted for *bona fide* non-tax purposes, such as to serve as a vehicle through which co-investors come into a particular investment. It seems somewhat arbitrary that the fact that the intermediate vehicle is an LLC (which it frequently would be), as opposed to a partnership, by itself, may be sufficient to engage rules that otherwise would not apply.

Where a fund invests directly into a CRIC, it could be concluded that subsection 212.3(2) would not apply since any CRIC controlled by the fund would usually not be controlled by a non-resident corporation, on the basis of the ownership attribution rule in subsection 212.3(7). A plain reading of proposed subsection 212.3(7) suggests that it imputes ownership of any shares in a CRIC that are owned by any partnership (including a private equity fund) to the partners based on the relative fair market value of their interests. Nonetheless, there is a concern that the language used in subsection 212.3(7) leaves open the possibility that the CRIC could be considered to be controlled by the general partner (usually a corporation) in the above scenario on the basis that the general partner has the right, subject to the investment restrictions and other terms of the partnership agreement (which require limited partner approval of specified matters), to vote all the shares of the CRIC actually owned by the partnership. We believe this is a debatable interpretation. While the general partner may well have "control in fact" in such a scenario, it may not have *de jure* control, since the voting rights relating to shares economically owned by the limited partners are obtained under the partnership agreement, which is not a "quasi-constitutional" agreement of the sort to be taken into account in assessing *de jure* control, as mandated by the decision in *Duha Printers*. Accordingly, as the matter is not completely settled, we believe a clarification is appropriate.[11]

[11] In this regard, we note that some uncertainty will inevitably arise with respect to the valuation of the general partner's "carried interest" or "promote" under which the general partner's entitlement depends on

Our larger concern is that we believe the legislation could be clearer in providing that the effect of the deeming provisions of subsection 212.3(7) is that control is assessed exclusively based on attributed ownership and not on any other basis. In brief, we believe this provision should clearly exclude from the application of subsection 212.3(2) a CRIC that is wholly owned by a particular partnership where the shares that are economically owned by any one corporate partner are not sufficient to give that partner control of the CRIC.

Thus, for example, it should be clear that subsection 212.3(2) does not apply to a private equity fund if

(a) the limited partners consist of disparate pension funds or other investors no one of which is a corporation that, on a look-through basis based on fair market value, owns CRIC shares sufficient to give it control, and

(b) the general partner of the fund is a corporation (such as a US LLC) that also, on a look-through basis, does not own a sufficient number of CRIC shares to give it control (based on relative fair market value, taking into account the need to determine the fair market value of the carried interest).

We believe this is a sensible result, since no non-resident corporation has a controlling position.

We have also considered whether it is reasonable to expect that the BPE, as currently formulated, is likely to be met (or not met) by CRICs controlled by or through private equity funds. In the experience of some members of the Committee, while it is true that private equity funds sometimes make significant changes to management of a portfolio company, installing new managers to "turn around" the business, this may or may not be the case in practice, and in any event it would be rare for the "factors" listed in subsection 212.3(5) to be met; in the real world, the fact patterns come in all shapes and sizes, and the listed factors posit a situation likely to be unattainable without significant restructuring designed specifically to meet these requirements.

Any material "investment" by a CRIC that is controlled by a private equity fund would almost certainly involve direction from the controlling shareholder. Further, the "best business case" test is just as unrealistic and unattainable for private equity funds as for other investors. Private equity funds often will acquire companies across jurisdictions in a particular line of business, and across different lines of business. The circumstances where it will be possible to show that the investment belongs in the CRIC to a greater extent than (as opposed to the same extent as) it belongs in any other corporation under common control would in practice be unusual. As noted in our comments on the BPE, we believe the BPE should in any event be re-oriented and one of its prongs expressed as a test that focuses on the real underlying rationale of the provision, namely base erosion.

Recommendation

For the reasons noted above, we believe the text of subsection 212.3(7) should be changed by adding a new paragraph (d) which states as follows:

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whether or not specified thresholds are met. Nonetheless, we do not see that uncertainty as necessarily insurmountable as valuation evidence can be brought to bear on the matter by both the taxpayer and the CRA.

(d) for the avoidance of doubt, in determining whether a CRIC is controlled by a non-resident corporation, where any share of capital stock is deemed to be owned by a particular person under paragraph (b), that share (and all rights derived by virtue of ownership of that share) shall be deemed to be owned solely by the particular person, and neither the share nor any such rights shall be considered to be owned or held by any other person or partnership.

While it may be argued that this additional language is unnecessary, we are concerned that in the absence of this clarification, there will be meaningful uncertainty as to whether or not a CRIC will be considered to be controlled by a non-resident corporation even where, on a look-through basis, there is in fact no non-resident corporation that has control.

We also recommend that a specific provision be added to accommodate circumstances in which a private equity fund holds an interest in a CRIC through a dedicated non-resident intermediary corporation.

D. Reorganizations

The proposed rules generally apply to any transaction whereby a CRIC acquires an "investment" (as described in subsection 212.3(3)) in a subject corporation that is or becomes a foreign affiliate. The only exception to the application of the rules is provided in paragraph 212.3(1)(c), the BPE. There are many examples of corporate reorganization transactions that involve the acquisition of an investment in a foreign affiliate, and it is unclear whether paragraph (c) would apply to provide relief. Given this uncertainty, we believe that an exception to the rules should be provided in the case of reorganization transactions that do not involve an increase in the net investment of a CRIC (and all non-arm's length CRICs) in the economic ownership of foreign affiliates.

This is not merely a grandfathering issue. Over time, this will be an issue with respect to reorganizations involving all investments, even those that were acquired after the Budget and were exempt from the rules due to the BPE. To provide certainty, it would be preferable to introduce reorganization exceptions, rather than having to test such reorganizations under paragraph (c).

In addition, there are certain transactions that require the acquisition of an interest in a foreign affiliate for a transitory period in order to facilitate an arm's length acquisition of a Canadian target company. These transactions should also be outside the scope of the rules.

To be clear, the focus of this exception should be on transactions that do not involve an increase in the net investment of a CRIC (and all non-arm's length CRICs) in the economic ownership of foreign affiliates, not on whether the transaction is governed by any specific reorganization or rollover provision in the Act.

Canadian Reorganizations

The rules could potentially apply to many common Canadian reorganization transactions. Consider the following discrete examples, mentioned here merely for illustrative purposes:

1. Canco 1 transfers FA to related Canco 2 for debt or cash of Canco 2;

2. Canadian Acquisitionco acquires Canadian Target which owns FAs. They amalgamate, and Amalco becomes the owner of the FAs.

3. Canadian Acquisitionco acquires Canadian Target which owns FAs. Canadian Target is liquidated into Canadian Acquisitionco, transferring ownership of the FAs to Canadian Acquisitionco;

4. Canco 2 transfers FA to its parent, Canco 1, as a dividend, return of capital or loan repayment.

5. Canco 1 and Canco 2 form a partnership. Canco 1 contributes a FA and Canco 2 contributes other assets. Pursuant to proposed paragraph 212.3(7)(b), Canco 2 would be deemed to have acquired a portion of FA, in proportion to the FMV of its interest in the partnership.

Even where the transaction is part of a series of transactions that is intended to be caught by the rules, only one such transaction per investment should be caught – say, in a series whereby Canco 1 acquires the SC from the Foreign Parent and then transfers it to Canco 2, which transfers it to Canco 3, and so on.

Recommendation

We recommend that the rules provide an exception for an investment in a SC acquired by a CRIC from another CRIC controlled by the same Foreign Parent (or a non-resident person not at arm's length with the Foreign Parent) at the time of the investment. If at all, the rules should potentially apply when the investment was made by the first CRIC to make it, and should not apply again when the investment is transferred within a related Canadian group, whether or not as part of the same series.

It is not clear that the recommended exception would provide relief in example 5, above. A special rule in respect of partnerships may be required to deem Canco 2 to have acquired the investment from Canco 1, similar to the rules in proposed draft Regulation 5908.

Foreign Reorganizations

Similar considerations apply when a CRIC acquires an investment in a SC in exchange for another investment in a SC or in consideration of a reduction in another investment in a SC. The rules should not apply unless the CRIC's net investment in SCs has increased. The following are some illustrative examples of transactions that may be caught by the rules, subject to the uncertain application of the BPE:

1. Canco owns FA. The capital of FA is reorganized and Canco exchanges its common shares of FA for new Class A common and Class B common shares of FA;

2. Canco transfers FA to FA Holdco in exchange for FA Holdco shares;

3. Canco transfers FA to FA Holdco for shares and debt of FA Holdco;

4. FA liquidates into Canco, transferring to Canco shares and debt of lower-tier FAs;

5. A top-tier FA transfers a lower-tier FA to Canco as a dividend, return of capital or debt repayment. The lower-tier FA becomes a top-tier FA.

6. CRIC makes a loan to a FA. The loan is subsequently re-negotiated in circumstances that cause the loan to be disposed of and replaced by a new loan.

Recommendation

The investment in the SC should be reduced by the value of the consideration provided for the investment that is another investment in a SC. This should include other FA shares or debt, the reduction of debt owed to the CRIC by a SC, and a dividend or return of capital from a SC.

We acknowledge that considerations that are relevant in the context of a "freeze" may be more complex unless the "freeze" is justified for business considerations and we believe they merit further review and consultation.

Transitory Foreign Affiliates

There are certain arm's-length acquisition transactions that may require a CRIC to acquire the shares of a non-resident corporation on a transitory basis in order to facilitate the acquisition of a Canadian company. An exception should be provided in such cases if the CRIC does not continue to own the subject corporation after a period of time.

For example, a CRIC may acquire shares of its Foreign Parent in order to provide those shares to the vendors of a Canadian company. The acquisition of the shares may result in the Foreign Parent becoming a foreign affiliate of the CRIC on a temporary basis. Another example may involve situations in which the series of transactions includes the acquisition of the shares of a related non-resident company other than the ultimate Foreign Parent, but again as a transitory step where the overall series contemplates the acquisition of a Canadian company. However, the Foreign Parent (or other non-resident company) will cease to be a foreign affiliate as part of the series of transactions.

Recommendation

An exception should be provided for an investment in a SC that is of a temporary nature. The rules should not apply if the investment (or a substituted property that is an investment in a SC) is not owned by the CRIC (or a non-arm's length CRIC) at a time that is [30 days] after the acquisition of the investment. In certain contexts, the exception should probably apply only if the investment results, or is part of a transaction or series of transactions or events that ultimately results, directly or indirectly, in the arm's-length acquisition of shares of a Canadian company.

4. Double and Inordinate Taxation

As noted above, we understand the FA Dumping Proposals are intended to get at both "debt dumping" and "surplus stripping". In the context of the question of what would be a countervailing consequence that defeats the tax benefits associated with such arrangements, we believe that these are very different situations and have very different tax consequences that depend on different factors – including, in the case of "surplus stripping" but not "debt dumping", the identity and residence of the Foreign Parent.

We understand further that Finance does not necessarily see "debt dumping" as being fundamentally different from the use of non-borrowed cash to acquire an investment in a foreign affiliate that may yield income but does not yield taxable income. Arguably, however, the acquisition of an investment in a foreign affiliate can only be seen as being similar to "debt dumping" to the extent that it reduces the Canadian tax base in an analogous manner – that is, where it does not yield taxable income (by analogy to yielding net deductions that can be taken in computing income or taxable income). That is one of the reasons why we have recommended above that investments that do yield sufficient taxable income should not be affected by the FA Dumping Proposals. In addition, our recommendation is premised on the notion that investments that continue to yield sufficient taxable income should not be considered to have been effectively extracted from the Canadian tax base, such that both under the rubric of "debt dumping" (and equivalents) and "surplus stripping" it is appropriate to exclude such investments from the scope of the FA Dumping Proposals.

Although the absence of taxable income (notwithstanding the presence of income) may in some respects be seen as equivalent to obtaining a net deduction, any tax benefit resulting from either of these would depend on the time horizon over which the investment is held, and would not depend on the identity or residence of the Foreign Parent. In that respect, both situations are different from "surplus stripping", since in that situation the tax benefit relates to the reduction, avoidance or deferral of a one-time charge under Part XIII at a particular rate that can range from 5% to 25%, depending on the identity and residence of the Foreign Parent.

We also understand that Finance has deliberately chosen to recommend the use of a deemed dividend (or PUC reduction) approach in all cases, notwithstanding these differences, for various reasons, including the desire to instill potential "downside risk" to engaging in the types of transactions envisioned by the FA Dumping Proposals, and to simplify the measures.

Nevertheless, it is our view that it is inconsistent both conceptually, and with the Government's objective to "strongly support" cross-border trade and investment, to premise the justification for the imposition of a deemed dividend on the conception that the CRIC making the investment is being directed by the Foreign Parent and should be treated as though it has constructively distributed an amount equal to the investment consideration to the Foreign Parent, and yet to not adjust the cross-border PUC (and adjusted cost base ("ACB"))[12] of the CRIC or a relevant other corporation in order to prevent full double taxation and otherwise inordinate taxation.

For example, if a CRIC had retained earnings of $100 not required for the purposes of its own business and, instead of paying a dividend to the Foreign Parent (assumed for purposes of this example to be the transaction that would have been done based purely on non-tax considerations), the CRIC acquired fixed-return preferred shares of a non-resident sister corporation controlled by the Foreign Parent, one might say this is a "surplus stripping" example as close as possible to the "debt dumping" example referred to in the AP Report.[13] If the

[12] The shares of the CRIC might be "taxable Canadian property".

[13] In some jurisdictions, the CRIC could perhaps directly acquire preferred shares of the Parent.

investment made by the CRIC triggers a deemed dividend, and there is no PUC adjustment, and the CRIC subsequently in fact distributes the $100 to the Foreign Parent (whether in cash or by distributing the investment), there may be full double taxation.

In our view, while we appreciate the analogy between obtaining a net deduction and deriving non-taxable income, there is double taxation except to the extent that the tax on a deemed dividend is justified by the reduction of taxable income that Canada can legitimately claim "belongs" in Canada, to use the same type of standard being used under the FA Dumping Proposals. Thus, in the example above, if the transaction presumed or determined to be that which would have been implemented purely for non-tax considerations is the payment of a dividend by the CRIC to the Foreign Parent, and assuming that it is not the Government's position that CRICs controlled by Foreign Parents should be discouraged from extracting the retained earnings of the CRIC by the imposition of charges exceeding the single imposition of the appropriate rate of Part XIII tax, it is difficult for us to see that Canada could legitimately claim to be properly entitled to collect more than a single incidence of the Part XIII tax – given that Canada would not have collected anything more than that (and might have collected less) if the retained earnings had in fact been paid out as a dividend.

This is not analogous to the "debt dumping" situation because there the source is a Canadian business, and the taxable income from that source is being reduced by net deductions relating to a different source. In other words, the "debt dumping" situation does not involve the relocation or extraction of business activities or non-financial assets from Canada, so Canada remains in the position where it is seeking to tax the Canadian source income of either a resident (i.e., the CRIC) or ultimately a non-resident (i.e., the Foreign Parent).

In contrast, where the asset in question is a financial asset that is not necessarily related to Canada, then it becomes very difficult in our view for Canada to justify both a tax under Part XIII and continued taxation of the value reflected by that asset in principle under Part I but under Part XIII as a proxy for that Part I tax. Indeed, that would be unprecedented as an approach under the Act – which contains many specific deemed dividend rules and consistently either adjusts PUC where they apply or provides for a refund on unwind.[14]

We appreciate that one might argue that double taxation can be avoided by the CRIC simply paying a dividend. However, in our experience, very often the more significant barrier to that alternative is the imposition of foreign taxes in respect of any such dividend. Thus, in this respect the FA Dumping Proposals would seem to put many taxpayers in a very difficult position of having to choose between double Canadian taxation and potentially even higher foreign taxation (as high as 40% in some countries, including the United States), which they may not have accounted for as a matter of financial statement presentation standards and practices because the items are "permanently reinvested" abroad from their perspective. In addition, we understand there is a degree of doubt that such double taxation would be "creditable" under the rules applicable in the United States, although we have not made any considered determinations in that regard.

[14] This principle is reflected also in rules such as subsection 80.4(3), which turns off the income attribution under that section if the loan has been included in the relevant taxpayer's income, as well as the general rule against duplication in subsection 248(28).

We are also concerned about situations in which the rules in subsection 212.3(2) apply to attribute 100% of any deemed dividend to the Foreign Parent notwithstanding that it may own only 51% of the equity of the CRIC. If the investment is funded using capital raised from an equity offering to the public or other arm's length persons, the Foreign Parent's interest in the CRIC is diluted and yet the Foreign Parent is deemed to receive a dividend equal to 100% of the investment. We believe it is fundamentally unfair and inappropriate for 100% of the cost to be borne by the Foreign Parent where it enjoys less than 100% of any tax benefit resulting from the investment.

Recommendations

Accordingly, on balance, while we appreciate that the issues are murkier in "debt dumping" situations, it is our view that the more appropriate treatment is to adjust PUC (or otherwise address double taxation) at least in "surplus stripping" situations and all situations in which the "specified tax benefit" (as described above) includes a reduction, avoidance or deferral of the Part XIII tax that would have been payable by the Foreign Parent on a dividend from the CRIC, and does not reflect net deductions in computing the income or taxable income of the CRIC or another relevant person. This would include all relevant cases of the deployment of cash or other property toward sources outside Canada that do not yield sufficient taxable income through an acquisition of an investment in a SC either from the Foreign Parent or another non-arm's length non-resident including the SC. This could be done with an actual PUC adjustment (together with an adjustment to cost base), or through a different approach such as an exemption from Part XIII for the distribution of (and, perhaps, also from Part I tax for) any taxable income arising to the CRIC from or from the disposition of an investment to which section 212.3 has applied. Another construct that might usefully be employed is the deemed loan-back concept reflected in subparagraph 78(1)(b)(ii).

Secondly, even in "debt dumping" situations where the investment is made for the purpose of increasing PUC with a view to increasing capacity to take deductions under the thin-capitalization rules, it would be more appropriate in our view to exclude the PUC from the formula in subsection 18(4) than to deny it for all purposes, since the PUC should be there to permit the extraction of value equal to the contribution, particularly if the increased thin-capitalization capacity is denied.

Third, we recommend that the amount of the deemed dividend where subsection 212.3(2) applies should be equal to the amount of the investment multiplied by a fraction the numerator of which is the fair market value of the Foreign Parent's equity interest in the CRIC and the denominator of which is the fair market value of all outstanding equity interests in the CRIC.[15]

Finally, we recommend that CRICs and Foreign Parents that are affected by subsection 212.3(2) should have an election to reduce existing cross-border PUC instead of having a deemed dividend.

[15] A comparable approach should be taken for transactions that give rise to a PUC reduction rather than a deemed dividend.

5. Narrower Technical Issues

A. Impact of overly broad wording

Pursuant to paragraph 212.3(2)(b), in computing the paid-up capital of shares of any class, there is to be deducted the amount of any increase, because of the investment, in the paid-up capital of the class, computed without reference to this section. This raises two interpretive issues. Firstly, the "because of" language could be interpreted more broadly than we understand is intended. For example, if the Foreign Parent subscribes for CRIC shares for cash and the CRIC uses the cash to make an investment in a SC, it might be said that the increase in the paid-up capital of the shares is because of the investment. Nonetheless, the investment itself would give rise to a deemed dividend under paragraph 212.3(2)(a). We understand that this is not the intention but rather, on these facts, only paragraph 212.3(2)(a) would apply. We believe that this should be clarified in the legislation.

Similarly, the "in respect of" language in paragraph 212.3(2)(a) might arguably be broad enough to trigger a deemed dividend when the Foreign Parent lends cash to CRIC and then another deemed dividend when CRIC uses that cash to make an investment. We also understand this "double hit" is not intended, and again would recommend the matter be clarified.

B. Interaction with other PUC grind rules

There is also an issue as to how paragraph 212.3(2)(b) meshes with other provisions of the Act that also provide for reductions in paid-up capital of shares, including subsections 51(3), 66.3(2), 66.3(4), 85(2.1), 85.1(2.1), 86(2.1), 87(3) and paragraphs 84.1(1)(a) and 212.1(1)(b). Each of these provisions deals with a particular type of transaction, but they do not apply simultaneously to a single transaction. That is, if subsection 85(2.1) applies, subsection 85.1(2.1) cannot apply, because a transaction is either governed by section 85 or 85.1, but not both. Similarly, a transaction governed by section 51 cannot also be governed by section 85 or 86, and a transaction governed by section 86 cannot also be governed by section 85. Moreover, if section 84.1 or 212.1 applies, subsection 85(2.1) will not apply, and section 84.1 and section 212.1 cannot both apply to the same transaction. Section 85.1 cannot apply if section 84.1 or 212.1 applies because they apply only where the transferor and the Canadian corporation acquiring the property do not deal at arm's length, and section 85.1 does not apply to a transaction between persons who do not deal at arm's length.

Each of these other provisions uses as the starting point the increase in the paid-up capital of the shares as a result of the particular transaction determined without reference to the particular provision. From that increase, the relevant deduction is made. However, it appears that certain transactions could give rise to a deduction in paid-up capital under both proposed section 212.3(2) and some other provision of the Act. For example, assume a Foreign Parent transfers shares of a non-resident corporation to a CRIC in exchange for shares of the CRIC and elects to defer its gain under section 85. Assume the transferred corporation thereby becomes a foreign affiliate of the CRIC, that section 212.3 applies, and that the full value of the transferred shares is added in computing the stated capital of the CRIC shares issued to the Foreign Parent. In this case, both subsection 85(2.1) and paragraph 212.3(2)(b) apply to require a deduction in computing the paid-up capital of the CRIC shares. It is not clear whether in interpreting the phrase "the increase, if any, determined without reference to this section" in subsection 85(2.1), it is appropriate to look at only the net increase (i.e., the increase after taking into account the deduction mandated by paragraph 212.3(2)(b), if it applies first). Similarly, if subsection 85(2.1) applies first, is the increase referred to in paragraph 212.3(2)(b) the net increase after taking into account the deduction mandated by subsection 85(2.1) or simply the increase without regard to subsection 85(2.1)?

Recommendation

Subsection 212.3(2) should be revised so that it is clear that

(a) where shares are issued in exchange for property which is not itself an investment in a SC, that those shares will not be considered issued because of the investment notwithstanding that the proceeds received in exchange for the shares might themselves be used to acquire an investment in a SC.

(b) where money or other property is transferred to the CRIC and then used as consideration for the investment in a SC, the first transfer does not give rise to a deemed dividend.

(c) in applying subsection 212.3(2), the starting point is the increase in paid-up capital after taking into account any deductions in computing paid-up capital required by any other provision of the Act that applies.

C. Beneficial owner of deemed dividend

A deemed dividend to the Foreign Parent can arise in circumstances where no amount is at any time remitted to the Foreign Parent. This raises a question regarding whether the Foreign Parent would be considered the "beneficial owner" of the deemed dividend for treaty purposes. Access to treaty-reduced rates – which we understand is generally intended – is normally premised on the recipient being the beneficial owner of the dividend. It is difficult, if not impossible to apply the conventional tests for determining beneficial ownership where the deemed dividend cannot be associated with any payment made at any time to the deemed recipient.

Recommendation

The legislation should explicitly deem the Foreign Parent to be the beneficial owner of any deemed dividend arising under section 212.3 for purposes of the application of any tax treaty.

D. Tiered Ownership

Since the Foreign Parent would be deemed to be the first non-resident in the chain that alone controls the CRIC (leading upward from the CRIC), there will be circumstances in which the Foreign Parent may not be entitled to the parent company rate of withholding tax under an applicable tax treaty because it is not the direct shareholder of the CRIC that is deemed to pay the dividend (i.e., where there is one or more other corporations, either another CRIC or a non-resident corporation, in the ownership chain).

Recommendation

The legislation should provide that the rate applicable to any deemed dividend is that which would be applicable if the Foreign Parent owned the shares in the CRIC that give rise to the Foreign Parent's control of the CRIC.

E. Sandwich Structures

There can be circumstances in which a CRIC is controlled by a non-resident corporation that itself is controlled by an ultimate parent that is a CRIC. This will arise, for example, where a CRIC acquires a non-resident corporation that has a CRIC subsidiary. It may not always be feasible to restructure such holdings so that the non-resident corporation ceases to control the CRIC subsidiary.

Recommendation

The legislation should exclude application to a particular CRIC that is controlled by a non-resident corporation where that non-resident corporation is controlled by another CRIC and the other CRIC is not controlled by a non-resident corporation.

F. Circular Shareholdings

Paragraph 212.3(1)(b) contains a reference to "another non-resident corporation". It is not clear whether this reference would include the Foreign Parent. If not, then section 212.3 would not apply where the CRIC acquires shares of the Foreign Parent.

Recommendation

The word "another" should be deleted.

G. Canadian Group Thresholds

Paragraph 212.3(5)(a) contains references to "subsidiary wholly-owned corporation". Assuming that it is decided to maintain that "factor", we have difficulty understanding why such an extremely high ownership threshold is necessary.

Recommendation

The legislation should accommodate circumstances in which the "connected business" is carried on by a CRIC that does not deal at arm's length with the CRIC that makes the investment in the SC.

6. Paragraph 128.1(1)(c.3) and 219.1(2)

We have not attempted to parse these provisions but we do observe that their scope is not consistent with the scope of section 212.3, both on the over-inclusive side and on the under-inclusive side.

Recommendation

The scope and drafting of these provisions should be revisited so as to be consistent with the scope of section 212.3.

7. Transition Rules

Many CRICs may have had legally binding arrangements in place as of Budget Day to make investments that cannot be unwound or that may trigger significant penalties. These commitments may require funding to be provided after 2012 over a schedule or on the basis of certain milestones.

Recommendation

We recommend that some limited grandfathering be available to accommodate post-2012 funding commitments that existed on Budget Day where the CRIC would otherwise be required to trigger penalties by unwinding these arrangements

Part II – Thin-Capitalization

1. Partnership Debts

A. Timing

The Thin-Cap Proposals propose to extend the thin-capitalization rules to debts owed by partnerships of which a Canadian-resident corporation is a member. For the purpose of determining the corporation's debt-to-equity ratio for the thin-capitalization rules, debts of the partnership will be allocated to its members based on the member's "specified proportion", within the meaning proposed to be assigned by subsection 248(1). A member's specified proportion for a fiscal period of a partnership generally is that member's share of the total income or loss for that period. However, that total cannot be determined until the end of the partnership's fiscal period.

Under the current rules, the debt component of a corporation's debt-to-equity ratio for a taxation year is determined by averaging all of the amounts each of which is the greatest total of outstanding debts to specified non-residents at any time in a calendar month that ends in the year.

We have several potential concerns regarding the allocation of partnership debt in this manner. First, it causes a problem where a partnership and a corporate member thereof have staggered year ends. The following example is illustrative. A partnership has a November 30 year end and a corporate member of that partnership has a December 31 year end. The corporation must determine its allocable share of the partnership's debt for December (at the latest, by June 30, when its tax return is due). However, the corporation may not be able to determine its specified proportion, and thus the proportion of partnership debt that is allocated to it for December, until the partnership's next year end.

Second, the determination of a corporation's specified proportion of a partnership on a current basis may make planning more difficult and could lead to anomalous results where the corporation's entitlement to income from the partnership varies significantly from year to year. This will be the case, for example, where the percentage of partnership interests or capital changes (by virtue of transfers, contributions, etc.) or where the partnership's income is allocated pursuant to a typical "waterfall".

Recommendations

We recommend that the proportion of the partnership's debt that is allocated to a corporate member be determined based on that partner's share of the total income or loss from the partnership for the partnership's previous fiscal period where the corporation was a member of the partnership in that fiscal period. If the corporation was not a member of the partnership in the prior fiscal period, the allocation would be based on the partner's share of the total income or loss from the partnership in the current fiscal period. In any case, debt should be attributed to an incoming or retiring partner only for the months (or part thereof) during the fiscal period during which it is actually a partner. The subsection 248(1) definition of "majority interest partner" makes a similar determination based on a partnership's previous fiscal period. This should solve most timing issues, and should allow the corporation to make an accurate analysis of its partnership debt attribution on a current basis.

We also ask that consideration be given to a special rule that would "smooth" the attribution in cases where the allocation of partnership income changes significantly from year to year (even though the allocation of income to the corporation over the life of the partnership is consistent with the partner's share of the partnership).

B. At-Risk Rules

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

Recommendation

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

C. Direct or Indirect Interest – Clause (31) and Proposed Section 212.3(7)

Both the Thin-Cap Proposals and subsection 212.3(7) (relevant to the FA Dumping Proposals and the amendments to the corporate migration rules) contemplate a direct or indirect interest in a partnership. The language used in the former is "directly or indirectly a member" and in the latter is "direct or indirect interest". We understand that these references are intended to refer only to circumstances in which a corporation is a member of a partnership that is itself a member of another partnership and that it is not intended to look through corporations, trusts or other arrangements, including rights to acquire partnership interests. While we believe that in most cases a partner of a partnership would, at law, also be considered a partner of any partnership of which the first partnership is a member, we acknowledge the desirability of making that clear, particularly given section 96. However, given the various meanings attributed to "direct or indirect" in the Act, we also believe that the intended scope of the provision must be made clear and that a mere reference to a direct or indirect interest in a partnership would lead to uncertainty as to the intended scope of the provision.

Recommendation

We recommend that the thin-capitalization rules and proposed subsection 212.3(7) be clarified so that it is clear that an indirect interest in a partnership means only that a partner of a particular partnership will be considered a partner of any partnership of which the particular partnership is a member (directly or indirectly through one or more partnerships).

2. Denied Interest Treated as a Dividend

A. Timing of Dividend

The Thin-Cap Proposals propose to recharacterize disallowed interest expense (including any amount that is required to be included in a corporation's income in respect of interest on partnership debt) as a dividend for the purpose of Part XIII non-resident withholding tax. The proposed rules allow a corporation to designate which amounts paid or credited as interest to the particular specified non-resident are to be recharacterized as dividends, to determine the time at which withholding should be made. However, where the disallowed interest is payable in respect of a taxation year of the corporation but has not been paid by the end of that taxation year, the disallowed interest will be deemed to have been paid by the corporation immediately before the end of that taxation year.

This deemed payment is earlier than deemed payments under other provisions of the Act, such as those under section 78 and subsection 15(2). Moreover, interest may be paid on the debt at regular intervals within a taxation year but not necessarily coincident with the corporation's taxation year end. For example, a corporation with an August 31 year end may have outstanding debt under which interest must be paid quarterly on March 31, June 30, September 30 and December 31 or semi-annually on June 30 and December 31. In those circumstances, it seems inappropriate to accelerate the withholding tax by several months simply because the taxation years and interest payment dates do not coincide.

We understand that the intention is that, where there is disallowed interest, the recharacterization will apply proportionately and separately to each debt owed to a specified non-resident so that, for example, if the proportion determined under subsection 18(4) is 5%, then 5% of the total interest paid or payable in respect of each debt owing to a specified non-resident in the taxation year will be recharacterized as a dividend and that the designation is solely for purposes of determining which interest payments on the particular debt paid to the particular non-resident will make up that 5%. Under the current rules, the taxpayer is simply required to compute an amount of interest that is disallowed without identifying which debts the disallowed interest relates to because it simply did not matter. Now this will be significant and we believe the manner in which the disallowed interest is allocated among debts should be clarified.

Recommendation

We recommend that, consistent with the timing in section 78, where disallowed interest is payable in respect of a taxation year (but is not actually paid), it not be deemed to be paid until the beginning of the third taxation year after the taxation year in which it became payable.

Alternatively, disallowed interest payable in respect of a taxation year but not paid in that taxation year should not be deemed to be paid until the day that is 12 months following the end of the taxation year in which it became payable.

The rules should be clarified with respect to the manner in which to allocate (among debts) any interest which is not deductible as a consequence of the application of the thin-capitalization rules and therefore deemed to be a dividend paid to a non-resident. This clarification might take the form of some examples in the Explanatory Notes.

B. NR4 Reporting

The Thin-Cap Proposals contemplate that interest subject to the thin-capitalization rules be deemed a dividend. Whether a particular payment of interest in a calendar year is deemed to be a dividend may not be known until well after the corporation's taxation year. Yet, payments made to a non-resident in a particular calendar year must be reported on an NR4 by March 31 of the following calendar year. Consider a corporation with a June 30 year end. That corporation may not know whether interest paid by it in the period July 1, 2012 to December 31, 2012 is recharacterized as a dividend under the Thin-Cap Proposals until after the end of its taxation year ending June 30, 2013 because, *inter alia*, it is events occurring after December 31, 2012 that result in the recharacterization. Nonetheless interest paid in that period must be reported on an NR4 no later than March 31, 2013. It may not be open to the corporation to designate interest payments in the January 1 to June 30, 2013 period to be those that should be recharacterized as dividends. For example, there may be insufficient payments of interest in that period (because the loan is repaid or has been refinanced with another creditor).

Moreover, if our recommendation above regarding the time at which interest that is payable but not paid is deemed paid is not accepted, the same issue may arise with respect to interest that is deemed paid in a calendar year but not known to be deemed paid until well after the following March 31.

Recommendation

We recommend that the legislation contain clear provisions that exempt a taxpayer from liability for interest or penalties for filing an NR4 without regard to a recharacterization of an amount of interest paid or deemed paid as a dividend under the Thin-Cap Proposals and provide a simple process for amending NR4s if it is subsequently determined that a payment or deemed payment of interest should be recharacterized as a dividend.

C. Retroactive Tax Liability

The Thin-Cap Proposals propose that the recharacterization of disallowed interest as a dividend will apply for taxation years that end on or after Budget Day. For taxation years that include Budget Day, the amount of the deemed dividend will be equal to the proportion of the disallowed interest that the number of days in the taxation year that are on or after Budget Day are of the total number of days in the taxation year. The effect of the foregoing is that disallowed interest paid prior to Budget Day may be retroactively subject to withholding tax. For example, if a corporation has a December 31 year end, and the only disallowed interest in its taxation year that includes Budget Day was paid to a U.S. resident before Budget Day, no withholding tax would have been imposed at the time it was paid. Following Budget Day, however, a portion of that interest, which has already been paid, will be recharacterized as a dividend and subject to withholding tax, albeit at a proportional rate. This is the case notwithstanding that no disallowed interest may be payable or paid after Budget Day, for example because the loan was fully repaid before Budget Day. This issue may be compounded if the non-resident to whom the interest was paid ceased to be a shareholder of the corporation before Budget Day so there is no prospect of collecting the withholding tax. We submit that such retroactive taxation is inappropriate.

Recommendation

We recommend that these rules be amended in a way that precludes the possibility of a retroactive tax liability. Having regard to the fundamental nature of this change, the effective date for this proposal should parallel that for the change in the debt-to-equity ratio.

D. Withholding Issues

Where a deemed dividend arises because of disallowed interest expense paid, or deemed to be paid, by a partnership of which a corporation is a member, the withholding obligation in respect of the deemed dividend is placed on the corporation. This may cause practical withholding issues. For example, since the partnership is paying the amount that gives rise to the deemed dividend, there is no payment made by the corporation from which to withhold, and the corporation might not have the liquid cash available to meet its withholding obligations. In some cases, the partnership may withhold on the interest payments at the applicable interest withholding rate, unaware that all or a portion of the interest may be recharacterized.

Recommendation

We recommend that where the partnership has withheld against the interest payment that relates to the proxy income of a corporation, the withholding should be credited against the corporation's withholding obligation. We also ask that consideration be given to providing some timing relief from withholding obligations, interest and penalties where the corporation has no means of immediately satisfying a withholding obligation that relates to the partnership. (Although the implicit premise underlying much of these rules is that the non-resident lender has full control over the Canadian corporation (and vice-versa), and that there will no issue with modifying existing arrangements, this is not always the case because a lender with only a 25 per cent share interest in the corporation is subject to the rules).

E. Late Withholding

It often will be the case that a corporation will not be aware that it has disallowed interest expense, or is deemed to have paid a dividend, until after the end of the taxation year (perhaps when it prepares its tax return for that year). Accordingly, a corporation may not be aware that it had a withholding obligation in respect of such a deemed dividend until well after the withholding obligation arose. In such a case, a corporation may attract penalties and interest charges for late withholding before such a time as it could determine that it had to withhold.

Moreover, the Thin-Cap Proposals give a corporation until its filing-due date for the taxation year to designate which payments are recharacterized as dividends, and until it does so, even if it is aware that it has potentially disallowed interest, it will not know which payments are recharacterized as dividends.

Recommendation

We recommend that a corporation not be liable for penalties and interest for late withholding in respect of withholding tax on deemed dividends (to the extent the amount of withholding exceeds the amount that should have been withheld if the recharacterization did not take place) resulting from Thin-Cap Proposals until the corporation's filing-due date for the taxation year in which the withholding obligation arose.

F. Over-withholding

A corporation may have withheld from an interest payment on the basis it was interest for withholding tax purposes but may subsequently determine that the amount is deemed a dividend under the Thin-Cap Proposals. This subsequent determination may occur *inter alia* because of a reassessment of the corporation. In some circumstances the rate of withholding applicable to dividends would be lower than the rate applicable to interest, in which case the non-resident will have been subject to over-withholding. However, under subsection 227(6), the non-resident is not able to apply for a refund of the overpayment unless it applies in writing not later than two years after the end of the calendar year in which the amount was paid. The reassessment of the debtor corporation giving rise to the recharacterization and overpayment may occur well after the expiry of that two year period, particularly where the corporation's taxation year is not the calendar year.

Recommendation

We recommend that the Act be amended to extend the period during which an application for a refund of an overpayment of Part XIII tax can be made to accommodate such overpayments.

G. Double Tax

We understand that the intent is that interest that is payable in respect of a particular taxation year that is recharacterized as a dividend under the Thin-Cap Proposals, and is therefore deemed paid at a particular time under clause 31(b), will be deemed to have been paid at that time and at no other time for all purposes of Part XIII. At the time of the deemed payment, it may not be known whether the payment is characterized as interest or a deemed dividend. The actual "interest" payment will occur at some later time, in accordance with the terms of the relevant debt instrument. We observe that paragraph 212(1)(b) refers to amounts paid as, on account or in lieu of payment of, or in satisfaction of interest. Similar language appears in subsection 212(2) in respect of dividends. We assume that the legislation will clarify that the subsequent payment of an amount on account of accrued but unpaid interest that was deemed paid as interest or as a dividend will be deemed not to be a payment as, on account or in lieu of payment or in satisfaction of, interest or a dividend for all purposes of Part XIII.

Recommendation

We recommend that the legislation clearly state that any amount deemed paid under the Thin-Cap Proposals prior to the date of the actual payment be exempt from withholding tax when paid.

3. Foreign Affiliate Loans

A. Split Structures

The Thin-Cap Proposals propose to exclude interest expense from the application of the thin-capitalization rules to the extent that a portion of the interest is taxable in the hands of the corporation in respect of the foreign accrual property income ("FAPI") of a controlled foreign affiliate (a "CFA") of the corporation. Where the CFA is not directly and wholly-owned, however, only a portion of the interest paid by the corporation will be included in the corporation's FAPI. Therefore, on a narrow reading of the Thin-Cap Proposals, only a portion of the interest will be relieved from the thin capitalization rules. We submit that the relief should be extended to the corporation to the extent that FAPI is included in the income of the corporation or other members of a broadly defined group (including FAPI which is earned indirectly through a flow-through entity).

Recommendation

We recommend that the rules be drafted to extend relief from disallowed interest expense to any interest paid by a corporation to the extent that the interest is taxable in the hands of the corporation or a member of this group.

B. Relief Only to the Extent of Net FAPI

The new rules only grant relief in respect of FAPI net any amount deductible in respect of foreign accrual tax ("FAT") under subsection 91(4). We submit that relief should not be limited to net FAPI. To the extent that interest paid to a CFA is subject to tax by another jurisdiction, it is consistent with the FAPI rules to provide Canadian tax relief for this payment; it seems inconsistent with this general principle to reduce relief from denied interest expense in respect of the amount of foreign tax actually paid. In the alternative, if this relief is intended only to provide Canadian tax neutrality (i.e., not having a one-sided inclusion), it seems clear that Canadian withholding tax should not reduce the relief (even though it creates FAT) because Canada has benefitted from the withholding tax.

Recommendation

We recommend that relief be available to the full extent that interest paid to a CFA is included in the corporation's income in respect of FAPI, without netting-out any amount deductible in respect of FAT under subsection 91(4) (or, alternatively, only netting-out foreign tax payments.)

C. CFAs Under Partnerships

The wording of the current proposal may not be broad enough to include CFAs under partnerships. Relief is only granted to the extent that the interest paid is included in the corporation's income in respect of FAPI of a CFA of the corporation. Where a partnership owns a non-resident corporation, a corporation could be denied a deduction for interest paid to the non-resident corporation and yet indirectly have a portion of the interest included in income through the FAPI pick-up by the partnership.

Recommendation

We recommend that the wording of the foreign affiliate relief rules be drafted broadly to contemplate common foreign affiliate structures, many of which include partnerships at various levels.

D. Timing

Income in respect of FAPI is not included in a corporation's income until the end of the taxation year of the CFA that earned the FAPI. Therefore, there could be a timing issue where the year end of the corporation and the CFA do not coincide. In this case, interest (or a portion thereof) will be deducted (and disallowed) before the FAPI inclusion arises.

Recommendation

We recommend that the rules be drafted so that the relief is available where the associated FAPI is included in the corporation's current or next taxation year. If there is concern that transactions could be structured to avoid the subsequent FAPI attribution, an anti-avoidance rule could be added to recapture the interest expense in the Canadian corporation.

E. Upstream and Downstream Loans - Proportionality

When a Canadian-resident corporation has exceeded the permitted debt-to-equity ratio and has debts to both a foreign parent and a CFA, we understand that Finance intends that the amount of disallowed interest expense will be apportioned between the debts. However, in a situation where the CFA is wholly-owned, all of the interest paid to the CFA will be included in the corporation's FAPI. If the rules are narrowly drafted, there is a concern that the corporation will only be entitled to relief to the extent of the proportion of the disallowed interest expense that is paid to the CFA, even though all the interest paid to the CFA is FAPI.

Recommendation

We recommend that the rule be drafted so that interest denial is first attributable to a loan to a CFA to the extent that relief would be available under the foreign affiliate relief rules.

F. Circularity

The combination of the foreign affiliate loan rules and the recharacterization of disallowed interest expense as a dividend may cause a circularity problem where the CFA is resident in a jurisdiction in which the treaty rate of withholding for dividends differs from that for interest. In (not so) simple terms, as interest is recharacterized into dividends subject to higher Canadian withholding tax, FAT increases, net FAPI decreases, thin cap interest relief decreases, more interest is recharacterized as dividends, and so on. This calculation is also potentially affected by the payment of foreign tax.

Recommendation

The largest culprit in this circularity problem appears to be Canadian withholding tax. As noted above, at a minimum, we believe that Canadian withholding tax should not reduce the relief for interest expense under the foreign affiliate loan proposals. If this circularity issue continues to exist, the rules should be drafted in a manner which limits its prejudicial effect, consistent with the intent of the rules.