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

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Le 19 octobre 2011

Monsieur Brian Ernewein
Directeur général, Division de la législation de l'impôt
Direction de la politique de l'impôt
Ministère des Finances
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Objet : Mémoire sur les propositions relatives aux sociétés étrangères affiliées du 19 août 2011

Monsieur,

Nous sommes heureux de soumettre à votre attention notre mémoire qui porte sur le projet de loi publié le 19 août 2011 qui, nous croyons comprendre, constitue la dernière tranche des modifications apportées aux propositions précédentes sur la question, qui avaient été publiées le 20 décembre 2002 et le 27 février 2004.

Au-delà de nos quelques considérations de principe et recommandations techniques particulières visant à améliorer les règles proposées, nous voulons d'abord vous dire que ces propositions représentent pour nous une amélioration considérable par rapport à l'approche adoptée pour les modifications techniques de décembre 2002 et de février 2004. Plus précisément, le remplacement des règles relatives aux gains suspendus par le concept de surplus hybride constitue une simplification considérable des règles et aboutit à un régime plus facile à gérer, auquel il est plus facile de se conformer, et qui est en outre plus conforme à ce qui nous semble constituer les principes sous-jacents du régime réservé aux sociétés étrangères affiliées. Nous sommes en outre en accord avec les fondements de la solution proposée de dissocier le traitement fiscal canadien des distributions des sociétés étrangères affiliées de leur traitement selon la législation du pays étranger. La possibilité d'utiliser la valeur fiscale au lieu d'avoir à reconstituer le compte de capital versé de la société étrangère affiliée reçoit également notre approbation.

Le reste de nos commentaires de fond est résumé dans les points suivants, et est exposé plus en détail dans notre mémoire, qui contient également des recommandations plus techniques :

- N’appliquer que dans des circonstances bien ciblées l’interdiction du roulement des actions d’une société étrangère affiliée transférées à perte permettrait de focaliser sur la création de pertes en capital étrangères accumulées et de préserver la simplicité du régime actuel.

- Les règles relatives au surplus hybride devraient être limitées aux transactions avec lien de dépendance, étant donné la préoccupation importante que semble constituer pour vous la création artificielle ou prématurée de surplus exonérés.

- Il faudrait tenir compte de l’incidence de la nouvelle règle relative au dividende réputé sur les contribuables sans personnalité morale.

- L’utilité du paragraphe 5907 (2.02) mériterait d’être reconsidérée, la DGAE étant selon nous un outil plus approprié pour contrer l’usage abusif des règles relatives au surplus exempté.

Nous sommes également très préoccupés par les règles proposées relativement au «prêt en amont» (un terme qui ne convient pas toujours, car les règles portent sur un ensemble bien plus large d’opérations), pour une question de principe, mais aussi en raison du nombre considérable d’anomalies techniques que nous avons relevées. Bien que nous comprenions certaines de vos préoccupations, nous pensons que ces propositions ne devraient pas être adoptées sous leur forme actuelle. Nous recommandons plutôt de retirer ces règles du reste des propositions législatives et de les soumettre à un processus de consultation détaillé, qui permettrait de mieux cibler les usages abusifs tout en corrigeant les anomalies que nous avons relevées dans notre mémoire, ainsi que celles qui pourraient ressortir dans les prochains mois à mesure que les contribuables et leurs conseillers examinent les incidences de ces règles.

Plusieurs membres du comité mixte ont participé aux discussions relatives à notre mémoire et ont contribué à sa préparation, en particulier :

Penny Woolford
Mitchell Sherman
Siobhan Monaghan
Angelo Nikolakakis
Janice Russell
Anthony Strawson
Bill Brebber
Sandra Slaats

Nous souhaitons remercier Stephen Ruby, de Davies Ward Phillips & Vineberg S.E.N.C.R.L., s.r.l., Francis Favre, de KPMG s.r.l./S.E.N.C.R.L., et David Bunn, de Deloitte & Touche s.r.l., pour leur aide.

Nous serions heureux de vous rencontrer pour échanger sur ces questions et pour mieux comprendre vos objectifs en matière de politiques afin de vous aider à parvenir à des solutions, ainsi que pour discuter de nos recommandations techniques plus détaillées. Comme toujours, nous sommes reconnaissants de la possibilité qui nous est donnée d’offrir notre collaboration au processus législatif.

Espérant que nos commentaires vous seront utiles, nous vous prions d'agréer, Monsieur, nos salutations distinguées.

D. Bruce Ball
Président, Comité sur la fiscalité
L'Institut Canadien des Comptables Agréés

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

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Submission of the Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants regarding the August 19, 2011 Legislative Proposals in Respect of Foreign Affiliates

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 August 19, 2011 Legislative Proposals in Respect of Foreign Affiliates.

The following abbreviations are used throughout this submission:

2004 Proposals	The proposals in respect of foreign affiliates released on February 27, 2004
Act	Income Tax Act
August 19, 2011 Proposals	August 19, 2011 Legislative Proposals in Respect of Foreign Affiliates
ITR	Income Tax Regulations
FA	Foreign affiliate
FAPI	Foreign accrual property income
GAAR	General anti-avoidance rule

Unless otherwise indicated, references to subsections, paragraphs, etc. are to provisions of the Act as proposed to be amended under the August 19, 2011 Proposals.

COMMENTS ON PROPOSED AMENDMENTS

As set out in detail below, we have a number of comments with certain provisions of the August 19, 2011 Proposals which we believe should be addressed.

1. Use of Capital Losses to Offset FAPI Gains

The August 19, 2011 Proposals include new rules to prevent capital losses of a foreign affiliate from dispositions of non-excluded property(“**FACL**”) from being deducted against ordinary FAPI income for tax years of foreign affiliates ending after announcement date. As is currently the case for Canadian corporations, the FAPI capital losses of a foreign affiliate will now be deductible only against the FAPI capital gains of the affiliate.

Recommendation

The objective of the new FACL rules appears to be to put the treatment of capital gains and losses incurred by a foreign affiliate on par with the treatment of such items realised by the Canadian taxpayer directly. However, the taxpayer is put at a disadvantage because it could use its own current year and carry-over net capital losses to offset capital gains realised by it directly, but such losses cannot be used to offset FAPI. Under existing law, this disadvantage was in part offset by the ability to deduct FAPI capital losses against any source of FAPI, which will no longer be permitted under the August 19, 2011 Proposals. Since FAPI capital gains must be included in income of the taxpayer, we believe that it would be appropriate to allow for the claiming of the taxpayer’s Canadian allowable capital losses and net capital loss carry-overs to offset the portion of FAPI that is attributable to net taxable capital gains of the affiliate.

This new rule should apply to taxation years ending after announcement date.

2. Stop-Loss Rules under Subsection 85.1(3) and Paragraph 95(2)(c) Rollovers of Excluded Property

A consistent theme in a number of the rules including subsection 85.1(3) and paragraph 95(2)(c) is to prevent taxpayers from “transferring” inherent losses in foreign affiliate shares where the transaction qualifies as a rollover. Many Canadian multinationals move foreign affiliates around a group without concern for obtaining valuations. In most cases, these transactions are not undertaken with a Canadian tax motive. We understand that the new denial of the rollovers for accrued losses was motivated largely by the taxpayer’s ability to potentially duplicate capital losses on dispositions of FA shares which could be converted into FAPLs and deducted against FAPI from any source. In our view, the new requirement to stream such losses as FACLs and thereby prevent their deduction against non-capital gain sources of FAPI addresses most of the concerns, as FAPI from capital gains is not common. Any remaining potential for concern could be dealt with by more targeted rules that do not impair taxpayers’ ability to move foreign affiliate shares within a related group without worrying about valuations and potential loss in tax basis. Furthermore, the requirement to realize losses can also create blocking deficits which are artificial in the sense that they arise in a context where the rules generally contemplate a rollover, and do not represent the realisation of such losses through a third party transaction. Although the proposed changes are justified in part as harmonising the foreign affiliate rollovers with the rules applying in the domestic context (such as subsection 85(1)), in our view there are valid reasons to have a different approach in the foreign affiliate context than in the domestic context because in the domestic context dividends do not reduce tax basis if they exceed safe income, so a lower-tier dividend can pass through a higher-tier deficit without causing a basis grind when it comes out of the higher-tier company.

Recommendation

The denial of the rollover should apply only in targeted circumstances. For example, similar to existing subsection 85.1(4), the rule could provide that the rollover is denied only where, as part of the same series of transactions, a loss is triggered from the disposition of non-excluded property that is either the transferred shares or the consideration shares (or shares substituted for either). Alternatively, the denial of the rollover could be made subject to a purpose test which would deny the rollover (or the resulting FACL) where it may reasonably be considered that one of the main purposes of the series of transactions was to trigger a FACL.

3. Foreign Exchange Gains and Losses

a. Subsection 39(2)

Subsection 39(2) is being replaced by proposed subsections 39(1.1) and 39(2). The former, which applies only to individuals, will apply only where a gain is made (or loss sustained) from the disposition of currency other than Canadian currency.

New subsection 39(2) will apply only where a taxpayer has made a gain or sustained a loss "in respect of a foreign currency debt owing by the taxpayer." Foreign currency debt is defined as "a debt obligation denominated in a currency of a country other than Canada". It seems unlikely that a foreign currency hedge contract or foreign currency swap would constitute a foreign currency debt. Indeed the Act itself distinguishes such agreements from a debt obligation.[1] A taxpayer that has incurred a foreign currency debt may enter into an agreement under which it hedges that foreign currency exposure. On repayment of the debt, the taxpayer may realize a foreign exchange gain, but may have an offsetting loss as a result of fulfilling its obligations under the hedge. However, it is not clear that that loss is one that would always be recognized under subsection 39(1). It could be argued that a payment made under the derivative contract could be viewed as a disposition of cash for nil proceeds, thus resulting in a loss governed by subsection 39(1). However, it is not at all clear that cash should be considered a capital property subject to subsection 39(1), and there are other contexts in the Act where treating currency as capital property would clearly have inappropriate results (e.g., under the stop-loss rules in subsection 40(3.4) and the definition of “superficial loss” in section 54).

[1] See, for example, ss. 20(1)(l.1), 20.3(1) , 95(2)(g) and (g.01), definition of excluded property in s. 95(1), and proposed s. 122.1(1.3).

Recommendation

Subsection 39(2) should be amended to ensure that it applies to foreign exchange gains made and losses sustained under hedging, forward purchase and sale, or swap agreements in foreign currency which are on capital account. This might be accomplished by amending the preamble of subsection 39(2) to read as follows:

> *If, because of any fluctuation after 1971 in the value of a currency other than Canadian currency relative to Canadian currency, a taxpayer has made a gain or sustained a loss in respect of a foreign currency debt owing by the taxpayer* ***or as a result of an agreement to which the taxpayer is party that provides for the purchase, sale or exchange of currency or for payments based on changes in exchange rates, and that can reasonably be considered to have been made by the taxpayer to reduce its risk with respect to fluctuations in the value of currency,***

As an alternative to the current drafting approach of specifically listing the types of gains/losses to which subsection 39(2) applies, if the only intent is to exclude gains and losses from the redemption of shares and similar transactions, it may be more straightforward to simply amend existing subsection 39(2) to specifically exclude these types of transactions.

b. Subsection 111(12)

We observe that existing subsection 111(12) is limited to accrued gains or losses on foreign currency debt. Consistent with our recommendation regarding proposed subsection 39(2), we recommend that subsection 111(12) be amended to include "accrued" gains and losses under agreements of the nature described above. Thus, for example, a taxpayer with a loss under subsection 111(12) on a debt obligation but an offsetting capital gain on a hedge, could elect to increase the adjusted cost base of the hedging agreement under paragraph 111(4)(e).

c. Treatment of Loans Between FA and Canada

Loans between the Canadian taxpayer and a controlled foreign affiliate give rise to significant foreign exchange issues if they are not denominated in Canadian dollars (or the taxpayer's functional currency, if a functional currency election is made). This applies both to upstream and downstream loans, at least where the latter do not qualify for the stringent conditions in paragraph 95(2)(i).

Assume a taxpayer makes a loan of US $100 to its wholly-owned US subsidiary at a time when C$1 equals US $1. If the loan is subsequently repaid at a time where US$1 equals C$1.10, the taxpayer realises a taxable capital gain of $5, while the borrower realises a FACL of $5 (assuming paragraph 95(2)(i) is inapplicable). The FACL of $5 cannot be offset against the taxable capital gain realised by the taxpayer, even though economically the corporate group has not realised an economic gain.

If the loan is instead an upstream loan, the taxpayer would realise an allowable capital loss of $5 and the foreign affiliate would realise FAPI of $5. If our recommendation in point 1 is adopted, the taxpayer could shelter the $5 in FAPI attributable to a taxable capital gain with the $5 allowable capital loss. However, under existing law, no such matching can be achieved. Further, our recommendation in point 1 does not address the opposite scenario where the taxpayer has the capital gain and the foreign affiliate has the FACL.

Recommendation

A deduction should be allowed against a taxable capital gain realised on the repayment of foreign currency debt or amount receivable (whether the gain was realised under subsection 39(1) in respect of a receivable or subsection 39(2) in respect of a payable), equal to the amount of the FACL (if any) realised by a controlled foreign affiliate of the taxpayer in respect of the same debt multiplied by the taxpayer's participating percentage in the controlled foreign affiliate. The related FACL should be reduced by such deduction claimed by the taxpayer, and the loss should also be ignored for surplus purposes.

4. Hybrid Surplus Rules

The August 19, 2011 Proposals introduced a new category of surplus referred to as "hybrid surplus". Hybrid surplus will include 100% of the capital gains and capital losses that arise from a foreign affiliate's disposition of shares of another foreign affiliate, a partnership interest and certain financial instruments.

One-half of dividends from hybrid surplus will be eligible for a deduction in Canada, while the remaining half will be eligible for relief depending on the amount of foreign tax paid by the foreign affiliate on the capital gain.

These measures oblige taxpayers to repatriate an equal share of both portions (exempt and taxable with relief for underlying foreign tax) at the same time. The ordering of surplus distributions has been changed such that distributions will, absent any special elections, be considered to be made in the following order: exempt surplus, hybrid surplus, taxable surplus and pre-acquisition surplus. A proposed rule will allow taxpayers to select taxable surplus before hybrid surplus.

These rules apply starting August 19, 2011 for transactions with non-arm's length persons and after 2012 for transactions with arm's length persons.

a. Policy behind the proposals applying to transactions with arm's length parties

We had understood that the original policy behind the suspended gain rules was to prevent replicating or accelerating the recognition of exempt surplus through interaffiliate transfers. A sale outside the affiliated group, however, should not raise the same concern as it is presumably primarily business motivated. Thus, we are concerned that extending these rules to arm's length transactions creates additional complexity and discourages Canadian multinationals from repatriating funds back to Canada.

Recommendation

We recommend the application of the hybrid surplus rules be limited to non-arm's length transactions. We would appreciate the opportunity to discuss more fully the policy objectives of this change in approach to find other solutions to deal with any concern associated with arm's length dispositions. If the concern relates to deferring repatriation of taxable surplus by way of other forms of distributions such as upstream loans then this has already been dealt with in the proposals so it is not clear why this additional complexity is needed for arm's length dispositions.

b. Inclusion of Non-Taxable Half of Hybrid Surplus Dividends in the Capital Dividend Account

The concept of hybrid surplus appears to be aimed in part at achieving more consistency between the taxation of capital gains realized by a corporation from the disposition of its capital property directly and capital gains realized indirectly through its foreign affiliates. It would be consistent with this approach to include the non-taxable half of hybrid surplus dividends in a corporation's capital dividend account where the taxpayer is a private corporation.

Recommendation

We recommend that the non-taxable half of hybrid surplus dividends should be included in a private corporation's capital dividend account. Similarly, it would make sense from a policy perspective to also include the non-taxable portion of capital gains included in a controlled foreign affiliate's FAPI in the capital dividend account when the related surplus is distributed back to Canada, although we realise this may be difficult to draft as such gains are not tracked separately in the surplus accounts.

c. Hybrid Surplus Dividends and Claiming Capital Losses

The proposed introduction of hybrid surplus and the related restrictions with respect to distribution of hybrid surplus have the effect of taxing hybrid surplus dividends in a manner similar to capital gains. Taxpayers should generally not be taxed differently if they dispose of the shares of a foreign affiliate directly or dispose of shares of a foreign affiliate offshore and subsequently repatriate the net proceeds of disposition. Under current law, a direct disposition results in a taxable capital gain against which allowable capital losses may be claimed. However, if the gain from the disposition of a foreign affiliate is repatriated as hybrid surplus dividends, allowable capital losses cannot be claimed against such income.

Recommendation

We recommend that proposed subparagraph 113(1)(a.1)(ii) be amended to include such portion of a taxpayer's allowable capital losses as the taxpayer may elect or, in the alternative, the Act be amended to allow a taxpayer to designate some or all of the hybrid surplus dividend received as a taxable capital gain.

d. Hybrid Underlying Tax Applicable

The definition of "hybrid underlying tax applicable" differs from the existing definition of "underlying foreign tax applicable" in that it does not allow a disproportionate designation of underlying taxes to a particular dividend paid from hybrid surplus.

Under the existing system, a corporation receiving a distribution of these components together would be entitled to claim a deduction in respect of a disproportionate amount of the underlying foreign tax applicable to the taxable surplus dividend. Accordingly, the inability of a corporation to disproportionately allocate hybrid underlying tax appears to be inconsistent with Finance's stated intention that the hybrid surplus regime essentially retains the current principles inherent in the categorization of gains except for the requirement that both components of the gain (which under the existing system would be exempt and taxable surplus) be distributed together. .

Another aspect of this is that foreign tax is computed by reference to the rules that apply for determining the gain that is subject to tax in the foreign country. When compared to the calculation of the gain applying Canadian tax rules (which are relevant for purposes of determining the amount of hybrid surplus) timing issues and other differences can arise. Thus, allowing for a disproportionate designation ensures that full tax relief for the incidence of foreign tax is available regardless of how the gain is computed under foreign rules.

Recommendation

We recommend that the definition of "hybrid underlying tax applicable" be revised to allow for a disproportionate allocation of underlying taxes to a particular dividend paid from hybrid surplus. To be consistent with this change, the definition of safe income and tax-free surplus balance should be revised to include the grossed-up hybrid underlying tax applicable, not to exceed the balance of hybrid surplus.

e. Transitional concerns

The rules suspending gains on the sale of foreign affiliate shares within an affiliated group under the 2004 Proposals were intended to apply to transactions occurring after December 20, 2002. Although these rules are now being abandoned, many taxpayers have applied the proposed rules in the intervening period, as is permitted by the CRA. Under current rules, a transaction that would have been caught by those proposals now results in additional exempt and taxable surplus. In some cases, what is now such taxable surplus was returned to Canada or to other affiliates in the group under the assumption that such distributions would be treated as pre-acquisition surplus dividends and thus result in a basis reduction or potentially a taxable capital gain, but not a taxable surplus income inclusion.

Recommendation

Dealing with these earlier years may be complex during the transition period, but taxpayers should have an option to elect to treat these gains as suspended and only "released" if there is a triggering event. This election should apply to dispositions occurring between December 20, 2002 and August 19, 2011 to which proposed paragraph 95(2)(c.2) of the 2004 Proposals would have applied. The transitional rule could provide that any such suspended gains would become "unsuspended" and included in hybrid surplus as at August 19, 2011. Thus, taxpayers would only obtain this relief at the cost of subjecting these gains to the new regime, but transactions completed prior to the announcement date could be treated consistently with the previous proposals.

5. Reinstatement of Loss Triggered on Repayment of Debt

a. Foreign exchange losses on shares and the interaction of paragraphs 93(2.01)(b), 93(2.11)(b), 93(2.21)(b) and 93(2.31)(b) with subsections 40(3.6) and 40(3.4)

Paragraphs 93(2.01)(b), 93(2.11)(b), 93(2.21)(b) and 93(2.31)(b) allow a loss arising from a disposition of a share of a foreign affiliate or an interest in a partnership that holds a share of a foreign affiliate, to the extent such loss may reasonably be considered to be attributable to a foreign exchange fluctuation and the taxpayer has realized a corresponding foreign exchange gain in respect of a debt or hedge obligation that was incurred when the share was acquired.

The policy intent is to permit taxpayers that hedge their foreign exchange exposure arising from investing in shares of a foreign affiliate by borrowing in foreign currency or otherwise to also have an effective hedge for income tax purposes. In the absence of such a reinstatement rule, taxpayers that have implemented an effective hedge from an economic perspective would often see that hedge defeated from a tax perspective simply because of the direction in which the relevant exchange rates move. For example, a taxpayer that has borrowed and invested in US dollars would experience a foreign exchange loss on the repayment of the debt, and a corresponding foreign exchange gain on the disposition of its investment, if the US dollar appreciates relative to the Canadian dollar. Such a loss would not be stopped by any rule, so the hedge would be equally effective from an economic and tax perspective. In contrast, if the US dollar depreciates relative to the Canadian dollar, that taxpayer would experience a foreign exchange gain on the repayment of the debt and a corresponding loss on the disposition of its investment. It is that loss that could be displaced by the application of subsection 93(2), thereby destroying the economic hedge from a tax perspective. It is submitted that it is unfair for the taxpayer's position for tax purposes to be dependent purely on the direction in which the exchange rate moves.

Even more generally, it is submitted that subsection 93(2) is misplaced in the foreign affiliate context. This rule is somewhat modelled on subsection 112(3), but there are material differences between the context in which the two rules are applicable. In the domestic context, we do not maintain surplus accounts as such, and thus there is no reduction in a shareholder's cost base in a subsidiary where it receives dividends exceeding the realized income of the subsidiary. As a result, it is possible to "manufacture" losses by incorporating a subsidiary, then subscribing for its shares (with low PUC), then causing it to pay a dividend thereby depleting its value such that a loss can then be realized on the disposition of the shares. That is not the case in the foreign affiliate context, because such a series of transactions results in pre-acquisition surplus dividends that erode the cost base and thus preclude the manufactured loss. It seems inconsistent in our view that subsection 55(2) allows a gain to be reduced by virtue of a dividend out of realized earnings ("safe income"), including foreign affiliate surplus, but subsection 93(2) precludes a loss for the same dividends. In our view, the reduction of a gain is the same in principle as the increase of a loss – and we believe that neither should be adjusted by reason of the payment of dividends out of realized earnings. Thus, we would recommend that subsection 93(2) and related provisions should be removed from the Act, or narrowed substantially so that they only apply to manufactured losses. We also have additional specific recommendations in this connection, as described below.

Firstly, we note that the policy intent of the reinstatement rule being contemplated for subsection 93(2) would often be frustrated by subsections 40(3.4) or 40(3.6), which have the effect of suspending or denying the loss that is otherwise allowed under paragraphs 93(2.01)(b), 93(2.11)(b), 93(2.21)(b) and 93(2.31)(b).

Recommendation

We recommend that subsection 40(3.4) be amended to exclude from its application losses that are allowed under paragraphs 93(2.01)(b), 93(2.11)(b), 93(2.21)(b) and 93(2.31)(b) and that subsection 40(3.6) be amended to exclude from its application losses that are allowed under paragraph 93(2.01)(b) or 93(2.11)(b)**.**

b. Time Period to Match Gain and Loss

For the loss to be available, the property must be disposed of within 30 days before or after the corresponding foreign exchange gain was realized. Often the loss is accessed by liquidating a foreign affiliate with an inherent loss. From a practical perspective, it may be difficult to achieve a liquidation or dissolution of a foreign affiliate under foreign laws within this time frame. There may also often be other valid reasons why this timing requirement cannot feasibly be satisfied.

Recommendation

We recommend that the time period within which the gains and losses must be realized be extended. In our view, it would be appropriate to allow the matching if the capital gain is realized at any time before the loss, or if the capital gain and loss are realised or deemed to be realized within the same taxation year. For this purpose, we would recommend a supporting rule be adopted that would allow the taxpayer to elect to realise either an unrealized gain or loss to match a realized corresponding loss or gain within the same taxation year (with appropriate tax attribute adjustments and deemed use rules).

c. Related Party Borrowings and Hedges

It is common as a matter of corporate and commercial practice for arm's length borrowings and hedges to be entered into by the parent of the corporate group, which may or may not be the relevant taxpayer with respect to the corporate group's investment in a foreign affiliate. Typically, where the foreign affiliate investment is held by a subsidiary rather than the parent, funding raised by the parent would be invested by it in the subsidiary, which would then invest in the foreign affiliate. Similarly, where an arm's length hedge is entered into by the parent, it would be typical for the parent and the subsidiary to enter into economically corresponding arrangements designed to "move" the parent's arm's length foreign exchange exposure into the subsidiary, leaving the parent "flat".

In such a case, the reinstatement rule, as drafted, would not be effective with respect to the subsidiary, because its immediate corresponding gain would arise under an arrangement with a non-arm's length person – being the parent.

Recommendation

We recommend that the reinstatement rule be modified so that it would permit a corresponding gain to be counted where it arises under an arrangement with a non-arm's length person, provided that the non-arm's length person also has a corresponding gain under an arrangement entered into (directly or indirectly) with an arm's length person (and to ensure that the non-arm's length person's loss arising under the arrangement with the subsidiary would not result in the subsidiary's gain being regarded as a "specified gain").

6. Foreign Affiliate Distributions

Proposed subsection 90(2) deems all pro-rata distributions received on a foreign affiliate share (other than liquidating distributions and share redemptions) to be dividends, regardless of their legal character. Where the recipient of the dividend is a Canadian corporation, the new pre-acquisition surplus election in Regulation 5901(2)(b) allows the recipient to “access” its adjusted cost base (ACB) as a proxy for the foreign affiliate’s capital. In general, these are welcome changes for corporate taxpayers. In particular, the new rules will provide simplification by eliminating the need to refer to foreign corporate law in order to characterize a foreign distribution. However, we do have a number of comments on the specific application of this rule:

a. Non Pro-Rata Distributions from Foreign Affiliates

A non pro-rata distribution may arise in a number of different contexts when dealing with foreign entities that are treated as corporations for Canadian tax purposes but that have certain unusual attributes under the applicable foreign law. This may arise, for example, where each member’s interest in the foreign entity is represented by an undivided ownership interest in the equity of the entity. In such cases, a separate “capital account” is often maintained for each member, and thus distributions can be paid independently to each member, without it being possible to clearly say that each such membership interest represents shares of a separate class. In these cases, an issue may arise as to whether a distribution made to one member without the same distribution being made to other members could be treated as a shareholder benefit under section 15, because such distribution would not be a pro-rata distribution.

Recommendation

Consideration should be given to extending the deemed dividend concept to any distribution that is carried out in accordance with the provisions of the law governing the existence of the foreign affiliate (including constating documents such as by-laws, operating agreements, etc), and that is not a redemption of a specific share or received in the course of a liquidation or dissolution. In other words, subsection 15(1) should be limited to benefits extracted “informally” without going through the proper corporate law procedures; any other distributions of corporate property should be deemed to be a dividend. It is notable that, since the benefits of exempt surplus do not extend to individuals, such a rule would not change the tax treatment of “benefits” received by foreign affiliate shareholders who are individuals, as dividends would be taxed in the same manner as a section 15 benefit (as ordinary income). Corporate taxpayers would however be able to access the benefits of the foreign affiliate regime, which in our view is appropriate as the policy intent behind section 15 is to prevent individuals (or non-residents) from extracting corporate assets without paying tax and arguably should not apply to transactions within a corporate group.

b. Extend Pre-Acquisition Surplus Election to Lower Tier Dividends

A Canadian corporate taxpayer may only elect to treat a dividend as having been paid from pre-acquisition surplus rather than hybrid surplus or taxable surplus if the shares are owned directly. From a policy perspective, it seems this election should also be available for lower tier distributions (i.e. distributions received by one foreign affiliate from another).

Recommendation

We would recommend that this election should also be available for lower tier distributions (i.e., distributions received by one foreign affiliate from another).

c. Transitional Period

As noted above, the suspended gain rules were first introduced as draft legislation in 2002. Many taxpayers planned for certainty on distributions by structuring to repatriate capital rather than repatriate taxable surplus because of uncertainty with these rules or to ensure consistent treatment with foreign tax principles. Thus many taxpayers made distributions during the period December 20, 2002 to August 19, 2011 that were thought to qualify as a return of capital rather than a dividend. As noted above, under current law and in light of CRA's comments at the 2011 IFA Conference, some concern exists that distributions from capital accounts other than stated capital could be treated as fully taxable shareholder benefits. As a result, taxpayers should have the ability to apply the subsection 90(2) deemed dividend concept and the pre-acquisition surplus election over the entire transitional period.

Recommendation

d. The election to apply these rules retroactively as provided by clauses 24(2)(a) and 12(2) of the August 19, 2011 Proposals should apply to distributions made after December 20, 2002, as opposed to February 27, 2004. This will help taxpayers avoid potential uncertainty about the treatment of distributions from non-stated capital accounts, such as contributed surplus and share premium, over the entire period during which the previous suspended gain proposals were intended to be applicable. **Subsection 90(2) — Deemed Dividend Concept and Non-Corporate Taxpayers**

The pre-acquisition surplus election is only available if the recipient of the dividend is a Canadian corporation and the payor of the dividend is a foreign affiliate. Consequently, the proposed rules put non-corporate taxpayers at a disadvantage relative to current law, in that non-corporate taxpayers will no longer be able to access their capital in a foreign affiliate on a tax-free basis as a return of paid-up capital. This is inconsistent with the general principle in the Act that all shareholders of non-public corporations can recover their capital on a tax-free basis. While the election could be accessed, in theory, by interposing a Canadian holding company between a non-corporate taxpayer and a foreign affiliate, this would add additional and unneeded complexity and cost to existing structures. Further, interposing a Canadian holding company is not an option in many situations — for instance, a Canadian holding company cannot be inserted between a real estate investment trust (REIT) and a foreign affiliate without affecting the ability to flow through income to unit holders without any REIT-level taxation.

Further, the pre-acquisition surplus election is not available to a Canadian corporate shareholder if any shareholder of the foreign affiliate is a partnership of which the corporate taxpayer (or any other related

Canadian corporation in respect of which the foreign corporation is a foreign affiliate) is a member (proposed Regulation 5901(2)(b)(ii)).

Recommendation

We recommend that an election be introduced that permits a non-corporate shareholder of a foreign affiliate or a corporate shareholder in circumstances where Regulation 5901(2)(b)(ii) precludes making a pre-acquisition surplus election to treat all or a portion of a distribution by a foreign affiliate as a return of capital, so that the non-corporate shareholder can continue to access its capital in the foreign affiliate. To the extent the amount elected as a return of capital exceeds the ACB of the shares of the foreign affiliate, we suggest that the excess amount automatically be deemed a dividend and thus fully taxable to the non-corporate shareholder. This would prevent a non-corporate shareholder from converting a taxable dividend to capital gain under subsection 40(3).

Alternatively, consideration could be given to preserving the current law's return of paid-up capital treatment for non-corporate shareholders of a foreign affiliate, and for corporate shareholders in circumstances where Regulation 5901(2)(b)(ii) precludes making a pre-acquisition surplus election. For example, the parenthetical exception in subsection 90(2) could be amended by adding the following phrase:

> *"…or – where the taxpayer is an individual, a trust, or a corporation resident in Canada to which Regulation 5901(2)(b)(ii) applies – on a reduction of the paid-up capital of the corporation in respect of the share…".*

e. Subsection 90(2) and Paragraph 53(2)(b) — Paid-Up Capital Concept

To the extent that the paid-up capital of a foreign corporation remains relevant for Canadian tax purposes (i.e., for non-foreign affiliates and if our second recommendation in point 6d is adopted), the current law's uncertainty remains concerning the treatment of amounts contributed by shareholders that are included in capital accounts other than registered share capital under foreign corporate law. In our view, there is no reason from a policy perspective why the foreign corporate law treatment of these amounts should cause the resulting distributions to be treated as income (whether dividends or section 15 benefits) for Canadian tax purposes.

Recommendation

We recommend that the Act be amended to specifically provide that all amounts of money or other property that were contributed to a non-resident corporation in respect of shares issued by the corporation should be deemed included in the paid-up capital of the corporation. For example, a new subsection 90(2.1) could be added, which would state as follows:

> *90(2.1) Meaning of Paid-Up Capital – For purposes of this Act, the term "paid-up capital" of a class of shares of a non-resident corporation shall include all amounts that were previously contributed to the corporation on the issuance of shares of that class by the corporation and amounts contributed by a shareholder of that class that can reasonably be considered to have been contributed in respect of the shareholder's ownership of shares of that class.*

In this case, amending existing paragraph 53(2)(b) would be unnecessary. Since paragraph 53(2)(b) refers to the paid-up capital of a non-resident corporation, the new definition of "paid-up capital" referred to above would ensure that returns of share premium and contributed surplus would reduce the ACB of the corporation's shares in circumstances where new subsection 90(2) does not apply to treat the distribution as a dividend.

We suggest that new subsection 90(2.1) apply after August 19, 2011 with the ability to apply it after December 20, 2002 on an elective basis.

f. Foreign Divisive Reorganisations

Subsection 90(2) only applies to distributions that are made pro-rata on all the shares of a particular class. The corporate and tax laws of many foreign countries provide for specific rules governing "de-mergers" or "divisive reorganisations". In many cases, it is difficult to obtain comfort on the Canadian tax treatment of such transactions because neither the Act nor Canadian corporate law have similar concepts. For example, in many cases, assets may be transferred to a new corporation and shareholders of the existing corporation (or, sometimes, a "parent" several tiers up) may receive shares of the new corporation, without it being possible to say that under foreign law:

i. the transferor corporation received any consideration on the transfer of the assets to the new corporation and/or
ii. the shareholders received shares of the new corporation as a pro-rata distribution on the shares they previously held.

Thus, there is often a concern that subsection 15(1) could apply to create taxable benefits or FAPI as a result of such foreign reorganisations, and no rollover would be obtained on transfers of assets as a result of such transactions. In many cases, it is not possible to restructure the transaction to fit within existing exceptions in the Act even where the Canadian taxpayer has full control over the group (e.g., certain foreign rules specifically require that the transferor in the divisive reorganisation either cannot receive any consideration for assets transferred, or cannot receive consideration that exceeds the book value of the assets transferred).

Recommendation

We recommend that, similar to new subsection 95(4.2) for foreign absorptive mergers, the Act should provide a definition of foreign divisive reorganisation. In our view, the definition should be broadly drafted with only the following conditions:

- The transaction must be undertaken pursuant to a specific statutory scheme under the corporate law of the country in which the foreign affiliates are resident that is intended to allow for the formal de-merger, spin-off, or split-up of corporations established under that law.
- It should be reasonable to conclude that the foreign reorganisation does not result in a significant change in the ultimate indirect economic interest of the Canadian resident shareholder (and non-arm's length Canadian residents) in the types of assets of the foreign affiliates involved in the reorganisation (i.e., to prevent disguised sales/cash-outs), using an approach which is similar to the asset

classification approach used in the context of section 55 but based only on the distinction between excluded property and non-excluded property.

Where these conditions are met, the Act should provide for the following tax consequences:

- Subsections 15(1), 56(2), and 246(1) should be inapplicable to any benefits that may be considered to have been conferred on the Canadian taxpayer or any foreign affiliate of the taxpayer in the course of the reorganisation.
- If both the transferor and the ultimate transferee corporation are eligible controlled foreign affiliates (within the meaning of subsection 95(4)), all property disposed of by the transferor (whether excluded property or not) should be deemed disposed of for proceeds equal to the relevant cost base of the disposed property.
- In all other cases, the property should be deemed disposed of for proceeds equal to fair market value.
- The transferee should be deemed to have acquired the property at an amount equal to the transferor's deemed proceeds.
- Where the Canadian taxpayer or any foreign affiliate of the taxpayer receives shares or other property (as would be the case if assets are de-merged "upstream") as a result of the foreign reorganisation, the property should be deemed received as a dividend, and a dividend should be deemed paid up the chain from the transferor corporation to the recipient of the shares or other property. The amount of such deemed dividend should be equal to the aggregate deemed proceeds of disposition established above, less any liabilities assumed or cancelled by the transferee corporation.
- Where shares are received, the ACB of such shares should be deemed equal to the amount of the deemed dividend received, as determined in the previous point.

7. Upstream Loan Rules

The August 19, 2011 Proposals introduce new rules modelled on the current shareholder loan rules in subsection 15(2) of the Act, but with much broader application as the rules would also apply to loans between non-residents and in fact often will apply to "sidestream" and "downstream" loans as well. As outlined in more detail in our specific submissions below, we have considerable concerns with these proposals as currently drafted both from a policy perspective and due to the significant number of specific issues and anomalies that we have identified. This is particularly the case because they represent the reversal of a well accepted and long-standing position of the CRA that many taxpayers have been relying on for many years.

Accordingly, it is our principal submission that the Upstream Loan proposals should be severed from the remaining provisions in the August 19, 2011 Proposals, so that they can be reviewed in more detail through a consultative process involving the Department of Finance, CRA, and taxpayers, with the objective of fully clarifying the policy intent of these proposals and better targeting the rules to the concerns under the foreign affiliate rules that they are intended to address.

In addition, we outline below a number of specific issues and recommendations that we have identified to date. However, we would like to stress that this list is unlikely to be comprehensive, as new issues appear to be identified regularly as taxpayers and their advisors consider the impact of the proposals on specific client situations.

a. Policy Behind Application to Non-Resident Debtors

As currently drafted, the definition of specified debtor includes all non-arm's length non-residents, other than controlled foreign affiliates within the meaning of section 17. To the extent the "mischief" intended to be addressed by these rules is the ability of Canadian multinationals to effectively "permanently" repatriate taxable surplus without paying the applicable Canadian tax by means of upstream loans, it is not clear to us that the inclusion of non-arm's length non-residents in the definition of specified debtor is appropriate. Loans between two non-residents in our view are not a proxy for a distribution of taxable surplus back to the Canadian taxpayer, and thus the extended definition of specified debtor does not appear to be necessary to protect the integrity of the taxable surplus and hybrid surplus regimes.

Recommendation

The definition of specified debtor should be restricted to the taxpayer, non-arm's length persons *resident in Canada*, and partnerships in which the taxpayer or a non-arm's length Canadian resident is a member. To prevent taxpayers from trying to avoid the income inclusion by using a non-foreign affiliate as an intermediary, a specific rule could provide that subsection 90(4) would apply where a Canadian corporation receives a loan from any person (other than a related Canadian resident), and it is reasonable to conclude that such person made the loan or allowed it to remain outstanding because a foreign affiliate of the taxpayer made a loan or otherwise provided funding, directly or indirectly, to the particular person or a person not dealing at arm's length with such person.

If this recommendation is adopted, then some of the other issues below would become moot and the rules would become much easier to draft, comply with, and administer.

b. Two-Year Rule - Timing of Income Inclusion

If the two-year rule in paragraph 90(5)(a) is not met, the income inclusion occurs retrospectively on the day the loan was actually made, even though the determination as to whether this rule applies cannot be made until the end of the two-year period. Presumably, in such circumstances the taxpayer would be required to file an amended return to report the additional income. It is not clear whether under such circumstances CRA would levy interest and potentially late payment penalties. Given that the ability to make upstream loans has been a long-standing feature of the Canadian tax system, and often unwinding these loans will be complex due to the large accumulated balance and foreign tax and regulatory reasons, in our view, it would be inappropriate to charge interest and penalties if taxpayers are unable to unwind these balances within the two-year or five-year window.

Recommendation

We recommend that either the income inclusion under subsection 90(4) should occur in the taxation year in which the two-year window ends or, alternatively, that any additional income inclusion in the taxation year in which the loan is made that arises because of an amended tax return filed by the taxpayer within six months of the end of its taxation year that includes the end of the two-year window should not give rise to late payment interest and penalties, assuming the additional tax is paid with such an amended return. Although we acknowledge that this would be different from the way in which subsection 15(2) currently operates, it is consistent with other provisions in the Act dealing with broadly similar concerns, notably, subsection 78(2).

c. Two-Year Rule -Transitional Period Too Short for Many Commercial Loan Arrangements

Upstream loans have been a well-accepted repatriation strategy for many years and have been explicitly sanctioned by the CRA in rulings and technical interpretations. Relying on these rulings, some taxpayers have accumulated large balances, which can be difficult to unwind for commercial and foreign tax reasons (e.g., term loans without early repayment options; gains in the foreign country due to foreign exchange or interest rates). As a result, we believe that a transitional period longer than two years should be available, for existing loans outstanding on the announcement date.

Recommendation

We recommend that the transitional rules should provide that, for loans outstanding on August 19, 2011, no income inclusion should arise to the extent such loans are repaid or otherwise settled within the existing terms of the loan, perhaps with a caveat that the terms of the loan not be changed substantially following the announcement date. If such grandfathering proposal is not considered acceptable, in our view a more appropriate transitional period could be five years to allow time to arrange for loans to be unwound within a reasonable time.

d. No Hybrid or Taxable Surplus

The Technical Notes suggest that the policy intent of the new rules is to prevent taxpayers from getting the benefit of cash represented by taxable or hybrid surplus but at the same time unduly deferring or avoiding the related Canadian tax. However, as currently drafted, subsection 90(4) can and often will result in an income inclusion where neither the lender nor the foreign affiliate group as a whole has any taxable or hybrid surplus. This is inappropriate in light of the stated policy of these rules.

Recommendation

As a general rule, the income inclusion under subsection 90(4) should be limited to the amount that would have been included in the taxpayer's income if it had received a distribution equal to the lesser of the income inclusion under subsection 90(4) and the total income inclusion less related deductions for underlying foreign tax that the taxpayer would have suffered, if all foreign affiliates of the affiliate having taxable or hybrid surplus had paid such surplus up the chain to the taxpayer.

e. Exception for Arm's Length Terms and Conditions

Since we understand the policy intent of the Upstream Loan rules is to target transactions that reflect in substance a permanent distribution of funds to the Canadian taxpayer (or its non-resident parent), we feel it would be appropriate to make an exception for bona fide commercial loan agreements with arm's length terms and conditions, even where such loans are made between related parties. If the terms of a loan are truly arm's length, then by definition such loan would not have the characteristics of a synthetic distribution and thus should not be taxed as such.

Recommendation

We recommend that subsection 90(4) should not apply to a loan made under terms and conditions (in particular, with regards to principal amount, interest rate, and maturity/repayment terms) that arm's length parties would have entered into at the time the loan was made, provided the parties in fact comply with such terms throughout the period beginning at the time the loan was made an ending at the earlier of the end of the taxation year and the time the loan is repaid.

If you are not willing to consider such a general exception for all loans, we believe at least a targeted exception for loans between non-residents should be provided. For example, the exception could provide that subsection 90(4) would not apply where all of the following conditions are met:

- The specified debtor is a non-resident person;
- The interest income on the loan is included in the foreign affiliate lender's FAPI; and
- The interest rate on the loan is at least equal to the rate prescribed in Regulation 4301(a) (i.e., the rate for tax underpayments – 3 month T-bill rate plus 4%) at the time the loan is made and any renewal thereof.

f. Paragraph 90(5)(b) Exception too Narrow

If our recommendation in the preceding point for a general arm's length terms exception is not accepted, we would like to point out that the current exception in paragraph 90(5)(b) for loans incurred in the ordinary business of a money lender is still too narrow as it does not appear to contemplate situations where the creditor acquires existing loans and receivables as opposed to originating them, as is commonly the case in the financial industry (e.g., factoring of accounts receivable, mortgage and other loan securitisations, etc).

Recommendation

Paragraph 90(5)(b) should be extended to indebtedness *acquired* in the ordinary course of the creditor's business.

g. Requirement to Repay

To avoid the income inclusion or to obtain a deduction for a previous income inclusion, the loan must be repaid. With significant balances that have been used to fund other assets in the group or to pay dividends out to the shareholders, there may not be sufficient liquid assets to repay the loan. The current drafting of the provision means that the debtor may be different than the taxpayer. As a result, the taxpayer may have limited influence over the process by which the loan is settled. For example, a Canadian Parent corporation owns all the shares in a foreign affiliate and a Canadian subsidiary. The foreign affiliate has lent funds to the Canadian subsidiary. If that loan is "forgiven" then the subsidiary must reduce its tax attributes or trigger an income inclusion. The “upstream loan” rule still applies to the Canadian parent even though the loan has been settled. Alternatively, the foreign affiliate could distribute the loan receivable to the Canadian Parent. In neither case does the loan remain owing to a non-resident creditor, yet it appears that no deduction under subsection 90(9) would be available because the loan was not “repaid”. If the upstream loan is instead made to the direct Canadian shareholder and is subsequently forgiven, the shareholder will suffer a fully taxable income inclusion through the operation of subsections 15(1.2) and 15(1), while it does not seem that the conditions under subsection 90(4) or (9) to either exclude the income inclusion or claim a deduction are met, hence resulting in double taxation of the same amount.

Recommendation

Additional options should be available to settle the balance owing without triggering the duplication of an income inclusion and to facilitate the settlement of existing balances. These options should still result in consistency with the tax policy underlying the Proposals.

h. Definition of Specified Debtor

The definition of specified debtor currently includes all persons that are not dealing at arm’s length with the taxpayer. The determination of whether persons are dealing at arm’s length is a question of fact and there can often be significant uncertainty as to whether this test is met in bona fide commercial arrangements, such as joint ventures where no party has de jure control but one party is the operator, relationships between a franchisors and its franchisees, and the relationship between a fund manager and portfolio companies owned by the fund. In many of these cases, there may be a risk that unrelated parties may be considered to not deal at arm’s length and thus included in the definition of specified debtor, but they may not meet the definition of controlled foreign affiliate because the taxpayer does not have de jure control.

Recommendation

The reference in the definition of specified debtor to persons not dealing at arm’s length with the taxpayer should be replaced with a reference to persons related to the taxpayer.

i. No Relief For Change in Status of Foreign Affiliate Lender or Specified Debtor

As currently drafted, the determination of whether the lender is a foreign affiliate and whether the borrower is a specified debtor is made when the loan is advanced or the indebtedness is incurred. There does not seem to be any relief where the status of either entity subsequently changes. This leads to inappropriate results from a policy perspective, particularly in circumstances where the borrower is a person other than the taxpayer, because often the taxpayer may have no control over whether and when the loan will be repaid (unlike subsection 15(2), where the person with the tax exposure is always the borrower (or also the lender where the loan amount is subject to Part XIII tax), and thus presumably has at least some control over the repayment terms).

For example, assume Canco has a 20% interest in FA1 and FA2, which are controlled by foreign parent. FA1 makes a loan of $100 to FA2, and there is no surplus, so Canco has a potential income inclusion of

$20. Before the two-year period described in paragraph 90(5)(a) has expired, Canco sells its interest in FA1 and FA2, but the loan remains outstanding. In such circumstances, it does not seem that the exception in paragraph 90(5)(a) is met (because the loan was not repaid), yet it seems the conditions in subsection 90(4) are still met because the status as foreign affiliate and specified debtor is tested at the time the loan was made, as opposed to the end of the two-year period. Further, Canco may never be able to prove that the loan was ultimately repaid to claim a subsection 90(9) deduction.. In our view, the conditions for an income inclusion should cease where either the lender ceases to be a foreign affiliate of the taxpayer and/or the borrower ceases to be a specified debtor.

Recommendation

We recommend that the two-year exception in paragraph 90(5)(a) as well as the deduction in subsection 90(9) should be extended to cover not only loan repayments but also situations where either the lender ceases to be a foreign affiliate of the taxpayer or the borrower ceases to be a specified debtor. This relief could be limited so as to not apply in circumstances where the debt is transferred or assumed and the transferee or new debtor is a foreign affiliate or specified debtor, as the case may be, in respect of the taxpayer.

j. Paragraph 90(6)(a) and the determination of amounts under paragraphs 113(1)(a) and 113(1)(b)

Paragraph 90(6)(a) provides for a deduction in computing a taxpayer's income of an amount equal to the portion of the loan or indebtedness that hypothetically could give rise to a deduction under paragraphs 113(1)(a) to (b) if such portion of the loan or indebtedness were distributed as a dividend at the time the loan or indebtedness was made or incurred. One reading of paragraph 90(6)(a) is that surplus in the particular affiliate and any affiliate which is "upstream" of the particular affiliate is the only surplus relevant in the determination of the deduction under paragraphs 113(1)(a) to (b). Surplus in other foreign affiliates of the taxpayer is not relevant to the determination of the amount deductible under paragraphs 113(1)(a) to (b).

In many circumstances taxpayers' foreign affiliate groups include an affiliate that provides a centralized cash management or pooling function within the group. Often these particular affiliates have made the loans to the taxpayer. As such it is likely that some of the surplus that relates to the loan is not in the particular affiliate or in an affiliate that is upstream of the particular affiliate. Therefore, even though the loan may be derived from surplus of a foreign affiliate of the taxpayer such surplus does not give rise to a deductible amount under paragraph 90(6)(a).

Recommendation

Paragraph 90(6)(a) should be amended to provide for a deduction, up to the amount of the loan or indebtedness, of the amount that could be received by the taxpayer, directly or indirectly, as a deductible dividend, from *any* foreign affiliate of the taxpayer.

Such broad wording which does not contemplate a notional distribution of the loan or indebtedness is intended to address not only surplus that is downstream of the particular affiliate but also surplus that arises in any foreign affiliate of the taxpayer. The broad approach recognizes that generally the surplus of any foreign affiliate of a taxpayer is available to facilitate repatriations.

k. Paragraph 90(6)(a) – Amount of Notional Dividend

If our recommendation in the previous point to de-link the deduction from a notional distribution concept is *not* adopted, we would like to point out that there is a potential issue with the sentence requiring the amount of the notional deduction to be determined. As currently drafted, the taxpayer is required to demonstrate that a deduction would be available for the full amount of the notional dividends that are equal to the specified amount. This seems to suggest that if the available surplus is less than the specified amount, no partial deduction is available. Based on the language of the remainder of the provision and in particular the reference to "portion", we understand that this is not the intent – i.e., a partial deduction should be available.

Recommendation

The relevant portion of paragraph 90(6)(a) should be modified as follows:

> *"the taxpayer demonstrates that the portion would, if instead* ***the portion of*** *the specified amount in respect of the particular loan or indebtedness were….."*

l. Paragraph 90(6)(a) — No Relief for Tax Basis or Previously Taxed FAPI

As currently proposed, paragraph 90(6)(a) provides relief from the income inclusion in subsection 90(4) where, if a portion of the specified amount were instead distributed as a dividend, the taxpayer would obtain a full deduction for exempt surplus, hybrid surplus, and/or grossed-up underlying foreign tax (UFT) in respect of taxable or hybrid surplus. However, no relief is provided where the taxpayer has sufficient ACB and could have obtained a full deduction under paragraph 113(1)(d) either automatically or by virtue of making the pre-acquisition surplus election in Regulation 5901(2)(b). In our view, this gives rise to an inappropriate result.

For example, a taxpayer could capitalise a new foreign affiliate (and thus have full ACB but no surplus accounts) to lend funds to a related entity that is not a controlled foreign affiliate (CFA) within the meaning of section 17, but in which the taxpayer has a qualifying interest. In this case, interest income earned by the new affiliate would be recharacterised under paragraph 95(2)(a). Thus, this fact pattern is clearly contemplated by the legislation. Further, the loan is not used to avoid or defer tax on taxable or hybrid surplus. In these circumstances, the taxpayer should be able to claim relief for its ACB in the foreign affiliate.

A similar issue arises when the taxpayer has made downstream loans to any of the relevant foreign affiliates. If there was an actual distribution of funds, the taxpayer could use the tax basis in these loans to repatriate funds to Canada without any further Canadian tax without relying on surplus. Thus, it should be appropriate to include the ACB of such downstream loans in the determination of the "reserve" under subsection 90(6).

Lastly, the current wording of subsection 90(6) does not provide any relief where an amount of taxable surplus would be fully deductible pursuant to subsection 91(5) on account of previously taxed FAPI.

Recommendation

We recommend that the relief in paragraph 90(6)(a) should be extended to situations where the taxpayer would be able to claim a full deduction under paragraph 113(1)(d), either alone or in combination with paragraphs 113(1)(a) to (b), to the extent such deduction would not give rise to a capital gain under subsection 40(3) if the Act were read without reference to subsections 93(1.1) and (1.11). In other words, provided the taxpayer has sufficient ACB to cover the full amount of the pre-acquisition surplus dividend, paragraph 90(6)(a) relief should be available.

Further, we recommend that the relief be extended to take into account the taxpayer's ACB in a downstream loan to any of the relevant foreign affiliates in the chain of ownership. Similar to the test for dividends, the amount deductible should be the portion of the ACB of the loan that the taxpayer demonstrates would reasonably have been repaid.

Lastly, the relief in paragraph 90(6)(a) should also include any amounts that would be fully deductible pursuant to subsection 91(5) in computing the taxpayer's income had the taxpayer received an actual dividend from the foreign affiliate. To avoid duplication, the Act should provide that the ACB of the foreign affiliate, for purposes of the relief accorded to amounts fully deductible under paragraph 113(1)(d), should be computed after taking into account the notional subsection 91(5) deduction.

m. Paragraph 90(6)(b) — Denial of Relief where Dividends Paid

As currently drafted, paragraph 90(6)(b) denies a deduction if any dividends were paid to the taxpayer by any of the foreign affiliates in the chain of ownership above the affiliate making the loan. No concept of quantum is included, such that relief is denied even where, after the payment of the dividend, there would still be sufficient surplus to obtain a full deduction if the loan amount were paid as an additional separate dividend.

Assuming the intent is to provide relief in situations where dividend payments are restricted due to foreign corporate law or other reasons (e.g., regulatory restrictions), these restrictions may apply at any point in the chain above the lender affiliate. As such, it is not clear why the exemption should be denied because a higher-tier affiliate paid a dividend from surplus that is unrelated to the "blocked" affiliate(s) that made the upstream loan.

Recommendation

We recommend that paragraph 90(6)(b) should not apply to deny the deduction where the taxpayer demonstrates that the condition in paragraph 90(6)(a) is satisfied after the payment of the dividends referred to in paragraph 90(6)(b), i.e., tax attributes are sufficient to cover both the actual dividends paid and the hypothetical dividend in respect of the specified amount.

n. Subsection 90(10) — Definition of "Specified Amount"

As currently drafted, the income inclusion in subsection 90(4) is computed as the loan amount times the taxpayer's SEP in respect of the lender affiliate. This computation gives rise to inappropriate results where loans are made between foreign affiliates that are not CFAs within the meaning of section 17.

For example, assume a Canadian corporation (Canco) has a 20% interest in a large foreign affiliate group that is controlled by the Canadian corporation's foreign parent. For a variety of reasons, a large number of inter-affiliate loans are made within the foreign affiliate group (e.g., as part of a captive treasury company or cash sweep which takes excess cash from certain affiliates and lends it to affiliates requiring funding). These loans would currently qualify for paragraph 95(2)(a) treatment if the funds are ultimately used in the active business of the borrower affiliates, and would not be subject to subsection 17(2) if the funds originated outside Canada.

Under the proposals as currently drafted, Canco would have an income inclusion equal to 20% of the principal amount of each of these loans (unless sufficient underlying exempt surplus exists), even though it has exactly the same ownership interest in the borrower as it has in the lender and thus it could not be said that the lender made a "synthetic distribution" either back to Canco or outside of the Canadian cone.

A similar issue can arise where certain foreign affiliates are owned through a partnership in which a corporation related to the taxpayer is the general partner. In that case, the foreign affiliates owned by the partnership would be considered not to deal at arm's length with the taxpayer, yet they may not be controlled foreign affiliates because the look-through rules in subsection 95(2.01) allocate the deemed ownership by reference to the relative fair market values of the partnership interests irrespective of whether the partnership interests are voting general partner interests or non-voting limited partner interests.

In our view, given that the policy intent of subsection 90(4) appears to be to prevent "synthetic distributions" by foreign affiliates to their Canadian shareholders or related parties without paying tax on the underlying surplus, the income inclusion should represent a fair measure of the amount of funds that has effectively been "taken out" of the foreign affiliate group.

Recommendation

We recommend that the definition of "specified amount" should be amended to alter the definition of amount B as being the excess (if any) of the taxpayer's SEP in the lender affiliate over the taxpayer's SEP in the borrower. If the borrower is the taxpayer or a related corporation that is not a foreign affiliate, then the result of the formula would be the same as under the current language since the SEP in the borrower would be nil.

On the other hand, in the examples above, where the taxpayer has the same SEP in both the lender and the borrower, the income inclusion would be nil, which is appropriate since no funds have left the foreign affiliate group. Where the taxpayer's SEP in the borrower is less than in the lender (e.g., wholly owned FA makes a loan to a partially owned related FA), a partial income inclusion would arise. Where the SEP in the borrower is higher than in the lender, no income inclusion would arise, which seems appropriate given that the loan would not have the characteristics of a constructive distribution outside the Canadian cone.

o. Foreign Exchange Consequences of Upstream Loans and the Interaction with Surplus Calculating Currency

In certain cases, taxpayers have made upstream loans in lieu of paying dividends because amendments that would materially affect the determination of surplus had not yet been proposed, or they were the subject of comfort letters but no proposed legislation had been drafted, or they had been proposed but were subject to significant debate and uncertainty. Further, where the proposals had not progressed to enactment or substantial enactment, reliance on the proposed legislation would have resulted in significant and often material financial statement consequences.

For all of these reasons, often the only reasonable alternative for many taxpayers to repatriate earnings was to rely on the CRA's long-standing administrative practice regarding upstream loans. Further, to avoid the potential FAPI implications arising from foreign currency upstream loans, taxpayers often denominated their upstream loans in Canadian dollars. Until recently, taxpayers have been unable to maintain their surplus accounts in Canadian dollars. Even if the proposed amendments to ITR 5907(6) are enacted, such amendments generally restrict the use of Canadian dollars to situations where it is "reasonable in the circumstances".

The Canadian dollar has appreciated significantly in recent years against several foreign currencies, and in particular, the U.S. dollar. Where taxpayers have made Canadian dollar upstream loans of their surplus, the strengthening Canadian dollar has resulted in a significant shortfall in U.S. dollar surplus terms. The consequences of this shortfall will be Canadian tax on the ultimate repayment or inclusion under subsection 90(4) of the upstream loan, even though the taxpayer has made no net economic gain. By way of example, if a foreign affiliate had US$100 of exempt surplus at the end of 2004 and lent the US$100 to the taxpayer in Canadian dollars, the loan would have been C$121. If repaid as an exempt surplus dividend in 2011 when the Canadian dollar is at par, there is a C$21 shortfall.

Furthermore, for loans outstanding on August 19, 2011, the transitional rules provide that these amounts are deemed to be a separate loan that was received on August 19, 2011, and hence all the related rules, and in particular the measurement of available surplus relevant for subsection 90(6)(a), should be made as of that date.

This rule may give rise to a mismatch between the loan amount and available surplus balances. In particular, upstream loans are often made in Canadian dollars to avoid foreign exchange issues, while the underlying surplus balances are maintained in local currency. If the Canadian dollar appreciated between the time the loan was made and August 19, 2011, there may be insufficient exempt surplus to fully cover the loan, even though sufficient surplus existed at the time the loan was made.

Recommendation

We recommend that Finance amend the Act to allow taxpayers to elect to treat some or all of an upstream loan as a deemed dividend paid at the time of the advance, the amount of which is added to the adjusted cost base of the shares of the particular top-tier foreign affiliate. Taxpayers should be able to elect to apply the amendment for taxation years commencing after 1994. For loans outstanding as at August 19, 2011, the rules should clarify that the elected deemed dividend would occur at the time the advance was actually made and not on August 19, 2011.

p. Multiple Income Inclusions for Back-to-Back Loans

As currently drafted, the rules result in multiple income inclusions where the same funds are lent 'back-to-back' within a related foreign affiliate group that does not meet the section 17 controlled foreign affiliate definition. In our view, this result is inappropriate as it results in multiple taxation of what is essentially the same amount.

Recommendation

We recommend a rule similar to subsection 17(11.2) that would "collapse" back-to-back loans into a single deemed loan to which subsection 90(4) would apply only once. The rule should be clear that it applies on an iterative basis until all loans in the chain have been consolidated (to the extent of the amount of the smallest loan, if they are not all equal. This issue may be resolved if the preceding recommendation to determine the income inclusion based on the SEP differential is taken into account.

q. Multiple Income Inclusions Where Loans Moved Within the FA Group

Subsection 90(4) applies where a specified debtor "receives [….] a loan from, or becomes […] indebted to, a creditor that is a foreign affiliate." The concept of "becoming indebted to" appears to be very broad and is intended to capture debts that may not be "loans" at law. However, this broad definition in conjunction with the lack of recognition of debt settlements other than by means of repayment (discussed in point g. above) could inappropriately give rise to multiple income inclusions where the loan is transferred within a foreign affiliate group either by way of assignment (new creditor) or assumption (new debtor).

For example, assume Canco owns 100% of FA1 which in turn owns 100% of FA2. Canco also owns 100% of Finco, a wholly-owned foreign affiliate. FA2 made an upstream loan of $100 to Canco. FA2 then distributes the receivable to FA1 as a dividend-in-kind, and FA1 sells the receivable to Finco for cash. The loan ultimately remains outstanding for more than 2 years, and there is no surplus. In this scenario, it appears each of these transactions gives rise to a separate income inclusion, as follows:

- On the initial lending by FA2, the test in 90(4) is clearly met as Canco has received a loan from FA2.
- When the loan is distributed to FA1, although Canco has not received a loan from FA1, it has become indebted to FA1 as a result of the assignment.
- The same analysis applies when the loan is sold to Finco – Canco has become indebted to Finco as a result of the assignment.

Similar issues arise where a new debtor assumes the loan from an existing debtor, if both are specified debtors.

Recommendation

Subsection 90(4) should be amended to clarify that no income inclusion arises where the amount giving rise to the debtor-creditor relationship is already subject to subsection 90(4). For example, this could be achieved by adding the following parenthetical exception after "or becomes at that time indebted to"

(otherwise than as a result of a transaction whereby an existing debt owed to another foreign affiliate creditor has been acquired by the current creditor or an existing debt owed by another specified debtor has been assumed by the current debtor)

r. Interaction with Other Proposed Amendments to the Act and the ITR

Taxpayers with an upstream loan must either repay such loan within two years or rely on the deduction provided in proposed paragraph 90(6)(a). In either circumstance, taxpayers need to determine surplus for the purposes of paying a dividend to repay the upstream loan or for purposes of claiming a deduction under proposed paragraph 90(6)(a).

A significant number of proposed amendments to the Act and the ITR affect the determination of surplus, some of which have a material impact on historical surplus. If taxpayers rely on the surplus amendments prior to enactment and either pay dividends or claim a deduction under proposed paragraph 90(6)(a), potentially material effects on financial statements may result.

In particular, a common reason for making upstream loans is that taxpayers may have low underlying foreign tax in respect of taxable surplus. In the case of oil and gas companies, this situation often arises because foreign governments levy their taxes in the form of resource taxes rather than income taxes.

Proposed Regulation 5910 is intended to remedy this issue by deeming foreign resource taxes to be underlying foreign tax up to the amount of the Canadian corporate tax rate. However, although this regulation has been proposed in various forms for many years, it is still not considered substantively enacted for accounting purposes.

As a result, taxpayers that have upstream loans may have to report a tax provision on their financial statements if these rules are enacted first even though this balance would be relieved by the extended definition of underlying foreign tax. However, if subsection 90(4) is enacted before Regulation 5910, then taxpayers could no longer rely on upstream loans to argue indefinite deferral of the Canadian tax liability but still could not use Regulation 5910 to reflect the underlying foreign tax deduction for accounting purposes.

Recommendation

We recommend that all proposed amendments to the Act and the ITR that may affect the determination of surplus, and in particular Regulation 5910, be enacted either prior to, or contemporaneous with, the upstream loan rules.

s. Foreign Affiliates Held Through Partnerships

The upstream loan proposals do not adequately address situations where foreign affiliates are held through partnerships. For example, assume that a Canadian corporation (“Canco”) owns one foreign affiliate ("FA1") through a partnership and another foreign affiliate ("FA2") directly. If FA1 loans an amount to FA2, the upstream loan rule will apply in respect of the partnership on the basis that a FA of the partnership (FA1) has made a loan to a specified debtor of the partnership (FA2), notwithstanding that FA1 and FA2 are each controlled foreign affiliates of Canco within the meaning assigned by section 17.

FA2 is a specified debtor in respect of the partnership on the basis that it does not deal at arm's length with Canco (a corporate member of the partnership) and is not a controlled foreign affiliate of the partnership within the meaning assigned by section 17.

Further, it appears that the same loan can result in a subsection 90(4) income inclusion at both the partnership and corporate partner levels in certain cases. The definition of "specified debtor" contemplates a partnership being the taxpayer for purposes of subsection 90(4). At the same time, the look-through rule in section 93.1 has been extended to section 90 which means that a corporate partner can also be the taxpayer for purposes of subsection 90(4).

The "specified amount" in respect of the partnership is based on the surplus entitlement percentage ("SEP") the partnership would have in the foreign affiliate lender if the partnership were a corporation resident in Canada. Pursuant to proposed Regulation 5908(1), the corporate partner would also have a SEP in the foreign affiliate lender on a look-through basis. The post-amble to Regulation 5905(13) would not prevent the double counting of SEP in these circumstances since the partnership is not a corporation resident in Canada (notwithstanding that the definition of "specified amount" requires its SEP to be computed as if it were a corporation resident in Canada).

Recommendations

We recommend that the upstream loan rules be amended to address situations where foreign affiliates are held through a partnership. For instance, a deeming rule (similar to the one in existing paragraph 95(2)(n)) could be introduced to deem a non-resident entity that is a controlled foreign affiliate of a member of a partnership to be a controlled foreign affiliate of the partnership. Similar problems associated with the ownership of foreign affiliates through partnerships were the subject of a comfort letter dated May 26, 2011 and it might be convenient to address all such issues through the same amendment. Alternatively, the definition of "specified debtor" could be amended to exclude a non-resident corporation that is a controlled foreign affiliate of each corporate member of the partnership that does not deal at arm's length with the non-resident corporation (rather than basing the exclusion on whether the non-resident corporation is a controlled foreign affiliate of the partnership).

Further, we recommend that the upstream loan rules be amended to clarify whether the income inclusion under subsection 90(4) is intended to arise at the partnership or corporate partner level.

t. Application of ITR 5910 to taxation years that begin Before December 18, 2009

In determining the amount for purposes of B in Regulation 5910 for taxation years commencing before December 18, 2009 it was proposed that subsection (3) be read as follows:

> "(3) The amount determined under this subsection in respect of the business for the particular year is the amount that would, if the definition "earnings" in subsection 5907(1) were read without reference to its subparagraphs (a)(i) and (ii), be the foreign affiliate's earnings from the business in the taxing country for the particular year."

Proposed subsection 5910(3) has been repealed and replaced with new subsection 5907(2.03) and B of subsection 5910(1) has been amended to read as follows:

"B is the affiliate's earnings from the business for the particular year, and"

Therefore the proposed application rule for taxation years commencing before December 18, 2009 should be amended to reflect the above changes.

Recommendation

For taxation years commencing prior to December 18, 2009 earnings for the purposes of B of subsection 5910(1) should be determined as follows:

> "earnings for the purposes of B of subsection 5910(1) shall be the amount determined in respect of the business for the particular year, if the definition "earnings" in subsection 5907(1) were read without reference to its subparagraphs (a)(i) and (ii)"

u. Regulation 5910 — Extend to Mining Taxes

Regulation 5910 currently deems all or a portion of a "production tax" in respect of a foreign oil and gas business to be an income or profits tax and thus eligible for treatment as underlying foreign tax in respect of taxable surplus. A similar rule in subsection 126(5) allows all or a portion of such taxes to be eligible for a foreign business income tax credit. Production tax amount is defined in subsection 126(7) to be an amount payable to a foreign government that is computed by reference to the value of hydrocarbons produced less an allowance for operating and capital costs incurred, and that is not a royalty. Currently, this relief is limited to oil and gas businesses, even though many countries charge similar taxes on other natural resources, especially mining. From a policy perspective, we can see no reason why other types of natural resources should be treated less favourably than oil and gas.

Recommendation

We recommend that the definition of production tax amount and related provisions in subsection 126(5) and Regulation 5910 should be extended to cover any foreign resource extraction business and to include any similar taxes paid in respect of any other type of minerals or other natural resources.

v. Debts of Foreign Branch Operations of Canadian Insurers and Banks

In many respects, foreign branches of Canadian life insurance and bank corporations are treated in a manner similar to foreign affiliates of such corporations, particularly with respect to inter-affiliate lending, It appears that subsection 90(4) may apply to certain indebtedness of a foreign insurance or bank branch of a Canadian company owing to a foreign affiliate of the company, although amounts paid in respect of such indebtedness are specifically deemed to be active business income under subparagraph 95(2)(a)(ii) of the Act or are considered excluded loans under 95(2)(a.3) thus not resulting in FAPI, and as such the loans do not represent a synthetic distribution to the company. Another common situation where a foreign insurance branch may incur indebtedness is where certain of its risks are ceded to a related foreign affiliate under a reinsurance agreement on a funds withheld basis.

Recommendation

A specific exemption should be provided for indebtedness incurred as part of a foreign insurance or bank business of a Canadian resident corporation.

8. Subsection 93(1) Elections

a. Limitation of Elected Amount to Gain

Subsection 93(1) currently allows a taxpayer to elect an amount to be deemed a dividend up to the proceeds of disposition of the shares. The proposals would limit the elected amount to the gain (if any) realised from the disposition. We do not understand the policy rationale behind this change. The purpose of the election is to allow corporate taxpayers to access their surplus pools on foreign affiliate share dispositions without the need to pay actual dividends, as the payment of actual dividends may not be possible (e.g., due to foreign corporate law limitations on distributable reserves or in minority situations) or may result in additional foreign tax costs such as withholding taxes. In the context of this equivalency, limiting the election to the gain does not make sense since no such limitation applies to the payment of actual dividends. The current limitation to proceeds makes more sense conceptually as presumably a corporation cannot pay a dividend that exceeds the value of its net assets, which is presumably reflected in the proceeds received for the shares.

Recommendation

The proposed amendment to limit the elected amount on an actual (rather than deemed under subsection 93(1.1) or (1.11)) to the gain from the disposition of the shares should be abandoned and the existing limitation to proceeds should be retained.

b. Automatic Election for Lower Tier FA Sales

Many taxpayers have been relying on the 2004 Proposals to have an automatic deemed election on lower-tier sales of non-excluded property shares (or excluded property shares subject to certain reorganization provisions) and thus have not filed a subsection 93(1) election form to claim the deemed dividend (as would have been required under enacted law). Contrary to such expectations, subsection 93(1.1) now only applies prospectively unless the taxpayer makes the broader pre-acquisition surplus election. In many cases, the three-year extended deadline to file a subsection 93(1) election has now expired.

Recommendation

We recommend that a separate election should be available to apply paragraph 93(1.1)(a) (dealing with lower-tier FA share sales) retroactively to dispositions occurring after February 27, 2004, independently of the pre-acquisition surplus election in clause 24(2)(a).

c. Regulation 5902(6) – Deemed amount designated under subsection 93(1)

Subsection 93(1.1) was changed to apply to Canadian corporations that realise a gain under subsection 40(3) because of an election to pay a pre-acquisition surplus dividend under proposed 5901(2)(b). Where subsection 93(1.1) applies, paragraph 93(1.11)(b) provides that the corporation resident in Canada is deemed to have designated in its subsection 93(1) election the prescribed amount in respect of the disposition. There is no prescribed amount for this purpose. Regulation 5902(6) is limited to dispositions of shares of a foreign affiliate by another foreign affiliate so there is no prescribed amount where it is the Canadian corporation that is realizing a gain.

Recommendation

We recommend that the preamble of Regulation 5902(6) be amended to conform with the changes to section 93 as follows:

If at any time a corporation resident in Canada is deemed under subsection 93(1.11) of the Act to have made an election under subsection 93(1) of the Act in respect of a share of the capital stock of a particular foreign affiliate of the corporation disposed of by ***<u>it or by</u>*** *another foreign affiliate of the corporation, the prescribed amount is the lesser of*

9. Foreign Affiliate Liquidations

a. Paragraph 95(2)(e) — Deemed FAPI on Disposition of Inside Assets

If the liquidation of a foreign affiliate is not a designated liquidation and dissolution (DLAD), all property of the liquidating affiliate is deemed disposed of at FMV (except for shares of another FA that are excluded property, in which case proceeds are the relevant cost base (RCB)). In this case, any gains realized on the disposition of distributed assets will be FAPI whether they relate to excluded property or non- excluded property because B in the definition of FAPI refers to paragraph 95(2)(e) and not specifically to subparagraph 95(2)(e)(i), which is the RCB election provision.

In our view, it is not appropriate that FAPI be triggered on the disposition of excluded property in these circumstances, especially where the excluded property is active business assets of the liquidated affiliate and because in many cases the taxpayer will not have control over the structuring of a liquidation that is not a DLAD (e.g., 50% owned joint-venture affiliate owned by a CFA of the taxpayer).

Although current law has the same reference in B of the FAPI definition, its scope is much more limited as (i) paragraph 95(2)(e) only applies where lower-tier FA shares are distributed and (ii) the only gains governed by paragraph 95(2)(e) are gains on the disposition of the shares of the liquidated affiliate. That said, we do not see any policy reasons why gains on the shares of the liquidated affiliate should trigger FAPI either, if those shares are excluded property.

Recommendation

We recommend that B of the FAPI definition refer specifically to subparagraph 95(2)(e)(i), such that dispositions of excluded property only trigger FAPI where the taxpayer makes an RCB election to override the automatic rollover.

b. Subsections 88(3.3) and (3.4) – Suppression Election

Where a liquidation and dissolution of a top-tier foreign affiliate is a qualifying liquidation and dissolution ("**QLAD**"), the property distributed on the liquidation is deemed to have been disposed of by the disposing affiliate, and acquired by the taxpayer, at the relevant cost base ("**RCB**") of the property to the disposing affiliate. RCB is defined in subsection 95(4), in general terms, as the amount at which the property could be disposed of that would not result in any gain or loss, taking into account the carve-out rule in paragraph 95(2)(f.1). The taxpayer is deemed to have disposed of the shares of the disposing affiliate for proceeds of disposition equal to the cost amount of the distributed property received by the taxpayer, less any liabilities assumed by the taxpayer.

To the extent the taxpayer would otherwise realize a capital gain on the disposition of the shares of the disposing affiliate, the taxpayer has the ability to defer the recognition of the capital gain by electing under subsection 88(3.3) to reduce the amount at which one or more capital properties are deemed to have been disposed of by the disposing affiliate and acquired by the taxpayer (the "claimed amount"). However, pursuant to subsection 88(3.4), the election is deemed invalid if (i) the claimed amount in respect of a capital property exceeds its RCB or (ii) the aggregate suppression amount exceeds the gain that would otherwise have been realized on the disposition of the shares of the disposing affiliate.

In order to ensure that the election is not deemed invalid, a taxpayer would need to know with certainty the RCB of each distributed property, as well as the ACB of the shares of the disposing affiliate

Recommendation

We recommend that taxpayers be permitted to amend the suppression election in subsection 88(3.3) in circumstances where it is "just and reasonable" to permit an amendment, which should take into account tax assessments and reassessments as well as other circumstance where the information necessary to determine RCB and ACB is not known with certainty at the time the suppression election is required to be filed.

c. Extend Rollover Rules to Other Distributions

The 2004 Proposals contained rules that would have extended treatment similar to liquidations to other forms of distributions such as dividends and share redemptions. Particularly helpful was paragraph 95(2)(e.2), which provided that certain distributions substantially equivalent to a liquidation were deemed a liquidation for purposes of paragraph 95(2)(e.1) – this is helpful as in some countries it is customary to strip out all assets and then sell a corporation to a professional liquidator instead of doing an in-house liquidation. In our view, there is no reason why some of the tax relief provided to liquidations could not also be extended to other forms of affiliate distributions.

Recommendation

Proposed paragraph 95(2)(e.2) of the 2004 Proposals should be reinstated and made applicable to both paragraph 95(2)(e) and subsection 88(3) liquidations. Futher, consideration should be given whether the rollover treatment applicable to a DLAD and QLAD could also be extended to property distributed in other forms and, in particular, to share redemptions by a foreign affiliate outside of the liquidation context.

10. Other Surplus Rules

a. Regulations 5907(2.01) and (5.1) — Surplus Recognition on Foreign Tax Rollovers

Regulation 5907(2.01) is intended to override the general non-recognition treatment for surplus purposes of dispositions subject to foreign tax rollovers where the rollovers occur in the course of certain transactions whereby a business is transferred to a new legal entity with the purpose of then selling the shares to a third party. However, as currently drafted, Regulation 5907(2.01) only overrides Regulation 5907(2)(f)(ii) and (j)(iii) dealing with gains and losses on income account, but it does not appear to override the forced rollover in Regulation 5907(5.1) for capital gains and losses. Thus, capital gains/losses on active business assets are still “lost” for surplus purposes.

Recommendation

We recommend that Regulation 5907(2.01) provide that Regulation 5907(5.1) does not apply to any dispositions of property in the course of transactions covered by Regulation 5907(2.01).

b. Regulation 5907(7.1) – Foreign Dividend Tax Refunds

Regulation 5907(7.1) provides that where a corporation resident in Canada obtains a foreign tax credit as a result of the payment of a dividend by a foreign affiliate, that credit is deemed to be an additional dividend paid by the affiliate and the affiliate’s surplus is grossed up accordingly. It is proposed that this regulation be repealed on the basis that it was designed to accommodate U.K. advance corporations tax (ACT), which has been abolished. However, the U.K. is not the only country that operates this type of dividend refund system for shareholders. For example, Malta has a similar system whereby a shareholder (domestic or foreign) receiving a dividend from a Maltese company is entitled to a refund of a portion of the taxes paid by another distributing company.

Recommendation

We recommend that Regulation 5907(7.1) be retained. Further, this regulation should be broadened so that it applies not only to a tax credit obtained by the Canadian corporation, but also to tax credits or refunds obtained by a foreign affiliate of the corporation resident in Canada.

11. Proposed Regulation 5907(2.02)

We have significant concerns with proposed Regulation 5907(2.02) relating to the underlying policy of the provision, the proposed wording, and the consequences of its application. As we understand the provision, we believe that the following results are intended:

(a) the provision is modelled on, and directly incorporates the standards of, the general anti-avoidance rule in section 245 with one critical exception: the abuse/misuse standard in subsection 245(4) is not applicable. As stated in the Explanatory Notes, it is therefore intended that any tax-motivated transaction that creates exempt earnings is considered to be abusive, whether or not the abuse/misuse threshold considered in the GAAR jurisprudence would otherwise be applicable to that transaction;

(b) for the purpose of determining whether a transaction is an avoidance transaction in this provision, the creation of exempt earnings (or reduction of exempt loss) is deemed to be a tax benefit; and

(c) if the rule applies, the amount in issue is instead included in the affiliate's taxable earnings.

From a policy perspective, we strongly disagree with the direction of this provision. We do not understand the need for such an all-encompassing provision, and the Explanatory Notes do not comprehensively explain the nature or category of transactions with which Finance is actually concerned. A significant amount of jurisprudence now exists respecting the general anti-avoidance rule in section 245, and most of the debate in these cases involves whether a particular transaction gives rise to an abuse/misuse of the Act. We believe that by removing the safeguard of the abuse/misuse test, the threshold for the application of this provision is far too low, and many non-controversial transactions could potentially be caught. As an example, if the CRA is correct that filing an election is an "event", it appears that simply making a subsection 5907(2.1) election could trigger this provision. Obviously, this position is not supportable.

The cases that have considered the general anti-avoidance rule have clearly given effect to the important balance that Parliament sought to strike when it enacted section 245; tax planning in Canada should still be possible provided that the planning does not result in an abuse/misuse of the Act. In this respect, the courts have held that predictability, certainty and fairness are essential ingredients of our tax system. We do not understand why Finance believes that a different, and significantly lower, threshold is appropriate in the area of foreign affiliate planning, or why Finance believes that it is acceptable to abrogate the *Duke of Westminster* principle specifically in this context. If Finance is concerned with particular transactions, we suggest that a more specific anti-avoidance rule be enacted; for example, proposed subsection 95(3.8) (in the 2004 Proposals) is a specific anti-avoidance provision that contained significantly narrower conditions for its application.

We also have significant concerns about the application of this anti-avoidance provision in practice. Although the foreign affiliate rules have become more complex over time, the essence of the initial determination of surplus was intended to be simple — surplus is generally determined under foreign tax law so that the amount of surplus may be initially taken from the tax return of the foreign affiliate. Regulation 5907(2.02) will require every component of exempt surplus to be subject to an overriding factual review to determine whether the transaction that gave rise to the exempt surplus was primarily tax motivated. This will create significant additional complexity and uncertainty for taxpayers, particularly where the facts underlying the creation of the surplus are not readily available to the taxpayer. For example, in the context of surplus that was created a significant period of time before being repatriated to Canada, and surplus existing in foreign affiliates that are acquired through an arm's length acquisition of a Canadian corporation, it may be difficult or impossible for a taxpayer to establish that a transaction did not have a tax motivation.

We are also concerned about the wording of the provision. In particular, the determination of whether a transaction is an avoidance transaction is to be made on the assumption that the creation of exempt earnings is a tax benefit. Because the provision specifically deems any amount included in exempt earnings to be a tax benefit, any transaction that has as its primary purpose the earning of any amount included in exempt earnings (including, at its most basic, earning income from an active business) would fail the avoidance transaction test because the primary purpose of the transaction is to generate the earnings, and therefore to obtain that deemed tax benefit. Obviously, such a result was not intended. We suggest that the words "or would be (if the amount or portion were a tax benefit for the purposes of section 245 of the Act)," be removed from the provision. . In addition, we note that even with these words removed the provision can give rise to inappropriate tax consequences because a transaction can be an avoidance transaction with reference to some other tax benefit arising under the Act, having nothing to do with the surplus treatment of a particular amount, and which may be perfectly legitimate and acceptable under an "abuse" analysis carried out under subsection 245(4). If any exempt earnings were to arise by reason of the particular transaction, they would be reclassified as taxable earnings even though that classification is not what causes the particular transaction to be an avoidance transaction and notwithstanding that the tax benefit that causes the transaction to be an avoidance transaction is perfectly legitimate because it is not abusive in the circumstances. For example, a liquidation and dissolution (other than a "DLAD") of a particular foreign affiliate that holds shares of another affiliate as well as active operating assets may give rise to exempt earnings with respect to the disposition of the operating assets. If the liquidation and dissolution is motivated primarily by a desire to not recognize any gain in respect of the shares of the other affiliate, it may be an avoidance transaction, say because it prevents the realization of FAPI where the shares of the other affiliate are not excluded property. That benefit may be achieved, and may be legitimate, but the status of the transaction as an avoidance transaction could cause any exempt earnings arising in the circumstances to be reclassified. We suggest that the wording be revised to preclude this possibility. We also believe that the wording in (b) should be clarified to ensure that any applicable foreign tax is added to "underlying foreign tax".

Finally, we do not believe it is appropriate to simply deem the amount or portion referred to in the provision to be included in an affiliate's taxable earnings. Under the general anti-avoidance rule, if it applies, the tax consequences to a person are to be determined as is reasonable in the circumstances in order to deny the tax benefit. This rule allows a court to review a transaction, including the nature of the abuse/misuse in relation to the scheme of the Act, and then to determine the alternative tax consequences that are most appropriate.

Given the breadth of this provision as currently proposed, it is not clear to us that all affected transactions that create exempt earnings should instead result in the creation of taxable earnings. For example, if exempt earnings were prematurely recognized (to use an example from the Explanatory Notes to subsection 95(3.8)in the 2004 Proposals) from a tax-motivated transaction, but the foreign affiliate otherwise has no earnings or assets that would ever give rise to taxable surplus, the consequence of the premature recognition of exempt surplus should be to deny the creation of the exempt surplus, but not to create taxable surplus. We see no compelling reason why a court with a proper understanding of all the facts and circumstances in a particular case should not be left to determine the appropriate results of the application of this provision.

Recommendation

As noted above, we strongly believe that this provision should not be enacted. If Finance is concerned that particular transactions should be prevented, we recommend that a narrower, more focused anti-avoidance rule (or rules) be enacted. If that recommendation is not accepted, the wording of the provision should be changed in the manner noted above. Finally, we believe that the consequences of the application of this provision should be determined as is reasonable in the circumstances having regard to the nature of the underlying transaction.

12. Absorptive Mergers

Reorganization of foreign affiliates follows the corporate legal mechanism in the foreign country. While Canada does not have the corporate legal concept of an absorptive merger, foreign countries such as the U.S. use such a mechanic. A deeming provision is needed to reconcile the foreign legal mechanic of an absorptive merger with the principles in the Act. The deeming provision under subsection 95(4.2) provides such a reconciliation. However, its application is only limited to the foreign affiliate section of the Act. This could expose taxpayers to the uncertainty of how an absorptive merger should be characterized under other sections of the Act, and could possibly result in inconsistent characterization, if its application is not expanded to the rest of the Act.

Recommendation

The deeming rule for an absorptive merger should be applicable to the entire Act.

13. Prescribed Foreign Accrual Tax

Regulation 5907(1.3) provides that, where an affiliate earning FAPI is a member of a consolidated tax group, tax sharing payments made by the affiliate to another group member can qualify as foreign accrual tax ("FAT") if they can reasonably be considered to relate to the tax that the affiliate would have paid on its FAPI, if it had been taxable on a stand-alone basis.

Proposed regulation 5907(1.4) would deny this prescribed FAT to the extent the tax sharing payment can reasonably be considered to be in respect of a loss of another corporation, and that loss is not a FAPL. Proposed Regulations 5907(1.5) and (1.6) provide rules to re-instate the denied amount if, within the subsequent 5 years, all of the losses of the particular foreign affiliate and other group members can reasonably be considered to have been deducted against active business income and the taxpayer demonstrates that no other losses were or could reasonably have been claimed during that time. The reinstated FAT can then be claimed under the mechanism in subsection 91(4), which provides for a 6 year window to claim foreign taxes that can reasonably be considered to relate to a FAPI income inclusion.

While this rule is a welcome relief, we would like to point out a number of technical issues that, in our view, have the potential to deny this relief in inappropriate circumstances.

a. Requirement to Deduct All Losses

Proposed regulation 5907(1.6)(a) requires that all losses of the affiliate and group members must be fully deducted within the 5 year time window allowed by Regulation 5907(1.6)(c). While we understand that from a policy and administrative perspective it is appropriate to set a time limit within which the losses must be utilised, there are common circumstances under foreign law in which it will be impossible to utilise all losses within 5 years even where the foreign group has significant income and pays significant foreign tax. Examples include:

- Where a U.S. corporation becomes a member of a consolidated group, its pre-entry losses are ring-fenced and can only be deducted against income from that legal entity (referred to a "single return limitation year" or SRLY).
- Where a U.S. corporation undergoes an acquisition of control, its pre-acquisition of control losses are restricted such that the corporation can only claim a fixed amount per year in each of the remaining years in their original carry-forward period (the fixed amount is determined by applying a prescribed rate to the fair market value of the stock of the corporation at the time of acquisition).
- In many countries (particularly in Latin America but also increasingly in Europe), loss carry-forwards can only be claimed up to a specific percentage (typically 50% or 75%) of taxable income for the year.

In this respect, it is also not entirely clear whether the reference to "all losses of the particular affiliate and the other corporations […] for their taxation years ending in the FAPI year" refers just to current year losses realised in that year or to both current and carry-forward losses.

Recommendation

The condition in Regulation 5907(1.6)(a) should be modified to allow the prescribed FAT to be reinstated where both of the following conditions are met within the 5 year period:

- The foreign affiliate group has, in each of the taxation years, claimed the maximum amount of the losses as is permitted under the applicable foreign law, and
- The cumulative taxable income, after taking into account the losses claimed and after deducting any amounts included in FAPI during those subsequent years, reported by the consolidated group is at least equal to the FAPI amount in respect of which the prescribed FAT under Regulation 5907(1.3) is to be claimed.

The second condition should ensure that the consolidated group has reported overall unsheltered income at least equal to the FAPI, and therefore it is appropriate to provide relief for the tax sharing payment on the FAPI. The first condition would prevent taxpayers from simply voluntarily deferring the claim for tax losses until after the 5 year window expires.

b. Application of Rules where FA Transferred to Different Taxpayer

As currently drafted, Regulation 5907(1.5) seems to require that the Canadian taxpayer holding the foreign affiliate must be the same at the time the losses are utilised as at the time the FAPI was earned. Often, however, foreign affiliate shares will have been transferred to a different Canadian holding corporation within the group between the time the FAPI arose and the time the foreign losses are utilised. In such circumstances, no relief may be available.[2]

Recommendation

We recommend that a deeming rule be introduce providing that where foreign affiliate shares are transferred between related persons resident in Canada, the current holder of the shares is deemed to be the same taxpayer as the related transferor for purposes of Regulations 5907(1.3) through (1.7) and subsection 91(4). This could be coupled with a rule that prevents any taxpayer from claiming a deduction under subsection 91(4) if another related taxpayer has claimed a deduction for what reasonably may be considered the same amount of FAT.

c. Timing of 91(4) Deduction

The deduction under subsection 91(4) is claimed in the year when the related (actual or prescribed) FAT is paid and not in the year in which the FAPI was originally reported. Thus, if the deduction is claimed after the 3 year loss carry-back period has passed and the taxpayer has no or insufficient other sources of income, the deduction may not provide any tax relief. For the same reason, the taxpayer may not be able to set up a deferred tax asset for financial reporting purposes if the losses are expected to be utilised in years 4 and 5 and the taxpayer does not have a reasonable expectation of sufficient taxable income (which is often the case for a pure holding company).

Recommendation

We recommend that the Act be amended to provide an election whereby the taxpayer can choose to file an amended return and carry-back the subsection 91(4) deduction against the related FAPI income inclusion for the full 5 year period.

[2] Although it would seem that under a reasonable interpretation, if the affiliate is still a foreign affiliate of the original holder (e.g., drop down to a Canadian subsidiary of the original holder), the deduction may still be available to the original holder though this would not be the case on a transfer between sister companies.