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Le 15 octobre 2013

Monsieur Brian Ernewein
Directeur général, Division de la législation de l'impôt
Direction de la politique de l'impôt
Ministère des Finances
L'Esplanade, tour Est, 17e étage
140, rue O'Connor
Ottawa (Ontario) K1A 0G5

Monsieur,

Vous trouverez ci-joint notre mémoire sur les modifications que le ministère des Finances a publiées le 16 août 2013.

Plusieurs membres du Comité mixte, ainsi que d'autres personnes, ont pris part aux discussions sur notre mémoire et ont contribué à sa rédaction, notamment :

Michael McLaren (Thorstienssons LLP)
Darcy Moch (Bennett Jones LLP)
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Nous serions heureux de discuter de nos commentaires avec vous au moment qui vous conviendra.

Veuillez agréer, Monsieur, l'expression de nos sentiments distingués.

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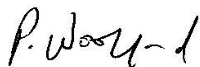

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The Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada is pleased to provide you with this written submission on certain aspects of the draft legislative proposals released on August 16, 2013 (the "**August Proposals**").

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the federal *Income Tax Act* (the "**Act**") as proposed to be amended under the August Proposals.

1. PLOI-Funding Indebtedness

a. Thin Capitalization Relief

The August Proposals would exclude from the definition of "outstanding debts to specified non-residents" in subsection 18(5) indebtedness that could reasonably be considered to directly or indirectly fund, in whole or in part, an amount owing to the corporation that is a "pertinent loan or indebtedness" (a "PLOI") as defined in subsection 212.3(11). While this relief is welcomed, we submit that similar relief should be available in respect of indebtedness that could reasonably be considered to directly or indirectly fund, in whole or in part, an amount owing to the corporation that is a PLOI as defined in subsection 15(2.11). We believe that the same policy considerations arise in both cases and thus their treatment should be consistent.

Furthermore, the August Proposals refer to "an amount owing to the corporation". We submit that this is too narrow because a debt obligation described in subparagraph (ii) of A in paragraph 17.1(1)(b) can be owing to the borrower corporation or to another corporation within the corporate group, or even to certain partnerships.

Recommendation

We recommend that proposed subparagraph (b)(ii) of the definition of "outstanding debts to specified non-residents" in subsection 18(5) be amended to apply to indebtedness that could reasonably be considered to directly or indirectly fund, in whole or in part, an amount owing that is a PLOI as defined in subsection 15(2.11) or subsection 212.3(11), owing to the corporation or to a non-arm's length corporation resident in Canada, or to a qualifying Canadian partnership of which the corporation or such non-arm's length resident is a member.

b. Withholding Tax Relief

We submit that the relief provided for by this proposal would be incomplete without additional relief with respect to the withholding tax normally applicable on payments of interest. Interest paid or credited to arm's length creditors is normally exempt from withholding tax. However, where the creditor is not arm's length, then relief is only available by treaty, which effectively limits the efficiency of such financing arrangements to US resident creditors, and even then would not be applicable if the Limitation on Benefits provision is engaged.

Recommendation

We recommend that Part XIII be amended to provide an exemption for interest paid or credited on indebtedness referred to in subparagraph (b)(ii) of the definition of "outstanding debts to specified non-residents" in subsection 18(5).

2. PUC Offset

The paid-up capital ("PUC") "offset" is a very important feature of the rules and we welcome your continuing efforts to improve its operation. In reviewing the August Proposals, we have developed a number of observations that we submit for your consideration, as described below. We have not taken the liberty to present for your consideration suggested revisions to the relevant statutory language with respect to all of our recommendations. The reason for this is the difficulty associated with this exercise. Unfortunately, we have not had enough time to work up a complete set of satisfactory proposals in this regard, that would address the various concerns in a manner that we believe is balanced. However, we have been working with a number of examples which we would welcome the opportunity to discuss with you in detail.

As the balance of this submission relates to section 212.3, we will generally be referring to its provisions without mention of the section number.

a. Automatic Offset

We believe the change to render the operation of the offset "automatic" will generally be welcomed. However, we believe that the drafting of subsections (3) and (7) could be improved in order to clarify that this is their effect.

Recommendation

We recommend that the wording of subsection (3) be revised to clarify that it is applicable only in respect of any deemed dividend remaining after the application of subsection (7).

b. Elective Lower Offset

While many taxpayers will prefer an automatic offset, there may be taxpayers that would prefer to preserve PUC and thus to have a deemed dividend under subsection (2) rather than an offset under subsection (7). We believe that subsection (7) should provide for an elective reduction of the offset amount. The default effect should be to trigger the offset, but taxpayers should have the ability to override this default effect by making an election. Where the offset would affect the shares of the CRIC (as defined in subsection (1)), then such an election could be made by the parent jointly with the CRIC. Where the offset would affect the shares of a qualifying substitute corporation (a "QSC"), then such an election could be made by the parent jointly with the QSC.

In addition, under the current rules, because the offset is not automatic in all cases, there may be taxpayers that have not elected, for example, to offset the PUC of a QSC, and have instead

suffered withholding tax in respect of a dividend deemed to have been paid by the CRIC or the QSC. Further, an investment that would qualify for the PUC offset under the August Proposals may not have qualified under the current rules. Because the August Proposals would be retroactive in this regard, we are concerned that the expectations of certain taxpayers with respect to completed transactions may be adversely affected. We believe taxpayers should have the ability to elect out of the retroactive application of the August Proposals.

Recommendation

We recommend that subsection (7) be revised to permit the relevant taxpayer(s) to elect a lesser offset amount – thereby triggering a higher deemed dividend.

At a minimum, we recommend that taxpayers should have the ability to elect prospective application of this aspect of the August Proposals.

c. Allocation

The August Proposals would require the offset to apply in a manner that results in the maximum reduction to the PUC of shares held by the parent or another non-resident corporation with which the parent does not deal at arm's length. Where there are two or more classes of shares, or two or more relevant corporations (be they two or more QSCs or one or more QSCs and the CRIC), it is conceivable that two or more different allocations of the reduction could satisfy this condition, but the rules are silent as to what to do in such a case. We believe that creates uncertainty or may even disable the application of the rule. Thus, we believe it would be preferable to provide for this possibility by adding a default allocation rule as well as an elective allocation rule. Where two or more different allocations of the reduction could satisfy this condition, we believe the allocations should be in proportion to the PUC of the relevant classes, or in such manner as the parent and the affected corporation(s) may elect.

Recommendation

We recommend that subsection (7) be revised to address circumstances in which more than one allocation of the reduction could satisfy the condition that there be a maximum reduction to the PUC of shares held by the parent or a non-arm's length non-resident corporation, providing for proportional reductions in the absence of an alternative elective allocation by the affected taxpayers. Such an election should only be required to be made by the parent and the corporation(s) that would have a reduction under the default rule, and perhaps it can be incorporated into the prescribed form contemplated in paragraph (7)(c).

d. Cross-Border Class

The August Proposals would define a "cross-border class" of shares of the capital stock of the CRIC, or a QSC, as a class any shares of which are owned at the dividend time by the parent, or another non-resident corporation with which the parent does not, at the dividend time, deal at arm's length. We believe that this condition is not necessary and may give rise to significant

hardship if retained. For example, where a CRIC issues a new class of shares exclusively to an arm's length party in order to fund an investment, the PUC of those shares would not be eligible for the offset. Under current rules, while the PUC of such shares cannot qualify for the offset under paragraph (6)(a), it can qualify under paragraph (6)(b), and in that sense the August Proposals are more restrictive.

In other respects, the August Proposals would appear to be more permissive than the current rules. For example, the PUC of a class some shares of which are held by a non-arm's length Canadian resident cannot qualify for the offset under paragraph (6)(b), although it can qualify under paragraph (6)(a). We believe that there are many circumstances in which it would be inappropriate to disqualify such PUC, but also others where it may be appropriate to disqualify such PUC.

This is the area where it has proven to be the most difficult for us to work up a set of satisfactory proposals for your consideration, and we would appreciate the opportunity to meet with you to discuss the examples we have been struggling with.

Recommendation

We recommend that the requirement, for a class to qualify as a "cross-border class", that at least one share of that class be held by the parent or a non-arm's length non-resident corporation, be deleted. At the same time, we appreciate that there should not be any duplicative offset, so it may be appropriate in some cases to restrict the offset to exclude the portion of the PUC of a class that relates to shares of that class held by a person resident in Canada that does not deal at arm's length with the parent. However, we have considered many examples where such a restriction would produce inappropriate results, and thus we would welcome the opportunity to meet with you to discuss these examples with a view to assisting you in developing satisfactory and balanced solutions.

At a minimum, grandfathering should be available to allow the PUC offset for those circumstances that met the requirements of (6)(b) of the current rules, as discussed in the first paragraph to this part (d).

e. Reporting

Our reading of the August Proposals suggests that the reporting contemplated by paragraph (7)(c) is just that – reporting, and not a condition to the application of subsection (7). However, it is conceivable that arguments to the contrary could be made, so we believe it would be desirable to clarify this point, perhaps even by putting the reporting obligation in a separate subsection.

In addition, we believe that it would be overly cumbersome for such reporting to be required for each investment made by a CRIC, and rather that instead such reporting should be required only monthly, in respect of all investments made in the preceding month.

Recommendation

We recommend that the wording and perhaps the placement of paragraph (7)(c) be clarified to preclude any argument that this provision sets out a condition to the application of subsection (7), except with respect to any election that may be provided for in accordance with our recommendation in relation to point (c) above.

In addition, we recommend that such reporting should only be required to be made on a monthly basis, for investments made during the preceding month.

3. Dividend Time – and Related Timing Issues

a. Simultaneous Loss of Parent Control

Under the current version of the rules, subsection (1) could conceptually apply to a foreign parent that acquired control of a CRIC as part of a series of transactions that included an investment in a subject corporation by the CRIC, even if that control was forever relinquished by the foreign parent prior to the time that the investment was actually made. We understand that the breadth of the series of transactions feature in paragraph (1)(b) is intended to address the opposite fact pattern, a deferred control situation where the foreign parent acquires control of a CRIC after the investment time but as part of the same series of transactions. In accordance with the August Proposals, an investment in a subject corporation is now subject to the rules only if the CRIC is "at the investment time", or becomes after the investment time and as part of a series of transactions, controlled by the foreign parent. This amendment addresses Finance's concerns regarding prospective (deferred) acquisitions of control as part of a series of transactions, but properly eliminates the risk that a former foreign parent may be subject to the rules.

We have also considered a number of situations where a CRIC ceases to be controlled by a foreign parent simultaneously with the making of an investment in a subject corporation. For example, assume that all of the issued and outstanding shares of the CRIC are owned by a single non-resident corporation, and that a wholly unrelated foreign corporation is owned by a single Canadian investor or broadly by public shareholders (in many jurisdictions). The proposed transaction contemplates the acquisition of the foreign corporation by the CRIC in exchange for the issuance of additional shares of the CRIC to the vending shareholder(s). The transaction could be structured, legally, as a share exchange, merger or plan of arrangement. As a result of the transaction, the issued and outstanding shares of the CRIC owned by the foreign parent would be significantly diluted below 50%, and no single non-resident corporation would acquire control of the CRIC. In this scenario, the CRIC will not be controlled by a single non-resident corporation following the transaction at any time as part of the same series of transactions.

Having regard to the principles noted above, we believe that the investment in the foreign corporation by the CRIC in this scenario should not be subject to the rules. However, there is some interpretational uncertainty in this regard because the two transactions (i.e., the

investment by the CRIC in the foreign corporation and the loss of control by the foreign parent) are simultaneous.

Recommendation

In order to fully clarify the non-application of the rules in these situations, we believe that the condition for the application of the rules in paragraph (1)(b) should be further amended to provide that the rules apply only where the CRIC is controlled by the foreign parent "immediately after the investment time", or the CRIC becomes controlled by the foreign parent at any time after the investment time and as part of the series of transactions that includes the investment.

b. Simultaneous Timing - Reduction of Deemed Dividend

Subsection (7) permits a dividend that would otherwise be deemed to arise under paragraph (2)(a) to be reduced where, instead, the PUC of shares of the capital stock of the CRIC, or of a QSC, is correspondingly reduced. For this purpose, under the August Proposals, the amount of PUC available for reduction is determined "immediately prior" to the dividend time. In a simple case where the CRIC is controlled by the foreign parent at the investment time, the dividend time means the investment time. Accordingly, in a situation where the investment time and the creation of PUC are simultaneous, it appears that the August Proposals do not permit a reduction which utilizes that PUC.

Consider, for example, a horizontal amalgamation of unrelated corporations to form Amalco (which is not relieved from the rules by virtue of subparagraphs (18)(a)(ii) or (18)(c)(ii) or paragraph (22)(a)), pursuant to which Amalco is treated as making an investment in a subject corporation by virtue of the amalgamation. In that situation, it is difficult to conclude that the PUC of the CRIC, being Amalco, existed "immediately prior to" the amalgamation (because the amalgamated corporation did not exist at that time), even where the predecessor corporations had significant PUC. Moreover, it is difficult to conclude that there was any QSC at that time, since no corporation would have had an "equity percentage" in Amalco before the formation of Amalco, even if it had an equity percentage in a predecessor of Amalco. However, the policy of the rules should be to permit the PUC of Amalco or of a QSC of a predecessor of Amalco to be reduced. Other examples of simultaneous PUC creation are also possible, for example, a three-party transaction where a CRIC makes an investment in a subject corporation and its parent, a QSC, simultaneously issues its shares to the transferors of the investment.

Recommendation

We recommend that the timing in the rules be amended so that the various provisions permit PUC that is created simultaneously with the dividend time to be reduced in accordance with subsection (7). This could be accomplished, for example, by allowing a reduction in PUC that existed "immediately following" the dividend time, or by changing the dividend time to occur immediately following the investment time (in this latter case, we would need to consider whether other timing issues might arise under the rules). We believe that this result is consistent with paragraph (2)(b), which allows an automatic reduction in PUC where shares of

the CRIC are issued in consideration for the acquisition by the CRIC of property that forms the investment in the subject corporation.

c. Deferred Control Transaction – 180 Day Limit

Proposed subsection (1.1) provides that "dividend time" means: (i) the investment time (where the CRIC is controlled by the foreign parent at that time) or; (ii) the earlier of 180 days following the investment time and the first time, after the investment time, at which the CRIC is actually controlled by the foreign parent. This aspect of the August Proposals addresses situations where the foreign parent acquires control of the CRIC as part of the series of transactions that includes the investment time, but following the investment time. We believe that this feature is welcomed, because a foreign parent which is subject to the rules in respect of an investment in a subject corporation should not be prejudiced simply because control is acquired following the making of the investment. In this situation, the foreign parent should be entitled to receive a reduced rate of withholding tax to the extent that a deemed dividend arises before the parent controls the CRIC, and should also be entitled to an offset of PUC that comes into existence after the investment time.

Our concern is that the 180-day limit may be too restrictive in situations where, for reasons beyond the control of the parties, a transaction cannot be completed within 180 days. We have considered the example of a merger transaction which is subject to significant regulatory and stakeholder approvals. Such a transaction would normally commence formally with the execution of a merger agreement between the foreign parent and the target, and the merger agreement would typically provide that the transaction would close as soon as any necessary approvals (including regulatory, stakeholder or third party approvals) were obtained. In the interim, it may be necessary for the target to make additional investments in existing subject corporations (in particular, investments that would otherwise have been made in the absence of the merger transaction). Although substantial arguments might be made that those investments should not be subject to the rules in any event (either because they should not be considered to be part of the same series of transactions or for other reasons), there is a residual concern that the rules could apply to the foreign parent as a result of those investments.

We assume that the 180-day limitation is intended to prevent avoidance or inordinate deferral of the rules in situations where the foreign parent purposely defers the actual acquisition of control of the CRIC. In the situation we have described, the delay in closing is beyond the reasonable control of the parties, and is in no way motivated by the application or non-application of the rules. In this situation, if the rules might apply to investments that are made by the target prior to the closing, we believe that the foreign parent should be entitled to the same relief under the rules as if it had actually controlled the target at the time the investments were made.

Recommendation

We believe that the definition of dividend time should be amended so that the 180 day limit is extended generally to a one-year period, and further in situations where the failure to close within the one-year period is reasonably beyond the control of the foreign parent. This request is analogous to other relief which Finance has recently provided. In the context of the synthetic

disposition rules, Finance has provided an exclusion for transactions which extend beyond the normal one-year limit because of a *bona fide* condition precedent, which includes a real risk that regulatory approval may not be obtained.

In addition, we believe that, following the actual acquisition of control by the foreign parent, the foreign parent should be entitled to apply for a refund/reduction of any withholding tax paid in respect of the investment and/or to reduce the PUC that existed in the CRIC or a QSC immediately after the actual acquisition of control.

4. PUC Reinstatement

Subsection (9) allows for a reinstatement of PUC in respect of a class of shares of a CRIC (or QSC) immediately before a reduction of capital in certain circumstances where the PUC was reduced through the operation of paragraph (2)(b) or (7)(b) as a result of an investment as described in subsection (10). We have several suggested changes to this provision.

a. Expansion of circumstances in which PUC is reinstated

We acknowledge that this version of subsection (9) has addressed some of the concerns expressed about the narrowness of the PUC reinstatement rule. However, we respectfully submit that the circumstances in which PUC is reinstated continue to be far too narrow and in many cases will result in a permanent PUC reduction or multiple deemed dividends in circumstances in which that result is unwarranted. In particular, in our view there is no reason to limit the PUC reinstatement to circumstances in which capital is distributed (whether by way of redemption of shares or otherwise). There is also no reason for a second, third or further PUC reduction to occur where one investment is replaced with another of equal or lesser cost. In many circumstances, notwithstanding a disposition of an investment, it will be impossible, highly impractical or undesirable to distribute the proceeds in order to obtain the PUC reinstatement notwithstanding that, in policy terms, the circumstances underlying the initial PUC reduction no longer apply.

For example, assume an investment of $1000 gave rise to a $1000 PUC reduction pursuant to subsection (7). If that investment is subsequently sold for $1500 and the best use of those proceeds is reinvestment, the taxpayer should not be required to distribute the $1000 on a reduction of capital to its shareholders and then seek to have the shareholders reinvest the funds in order to restore the PUC. In these circumstances, the distribution would serve no commercial purpose. In many circumstances the taxpayer will be precluded from making the distribution (for example, under covenants in its credit agreements) or the distribution will be highly impractical (for example, in a public corporation with minority shareholders). For these reasons, in our view, an approach that would be more fair, while doing no harm to the purpose of the rules, would provide for an automatic PUC reinstatement immediately before the disposition of an investment that gave rise to the PUC reduction. The amount by which the PUC would be increased would be limited to the prior reduction and, where only part of the investment was disposed of, to a proportionate share of the prior reduction.

If the proceeds are used to acquire an investment described in subsection (10), the reinstated PUC would be subject to reduction once again. This would be consistent with the policy

underlying the rules. However, it would also alleviate the multiple incidence of PUC reductions where one investment has been substituted for another. This principle may be illustrated by the following example.

CRIC is a public corporation controlled by a non-resident corporation (parent) which owns 55% of the common shares of CRIC. The balance of the common shares are widely-held and traded on the TSX. The PUC of the CRIC's common shares is $100 million. In 2013, CRIC uses $20 million of cash to acquire 100% of the shares of a foreign corporation ("CFA") from an arm's length person. As a result, the PUC of the CRIC's common shares is reduced to $80 million. In 2014, CRIC sells all of the shares of the CFA for $25 million and wants to reinvest those funds.

Under the current rules, the $20 million PUC would not be reinstated unless CRIC made a distribution of capital to all of its shareholders (including the minority shareholders). This is unlikely to be practical for several reasons. First, if CRIC has outstanding borrowings, the lender may insist that it be repaid before any distributions are made to the shareholders. Secondly, if 45% of the proceeds are distributed to the minority shareholders, it may not be possible or practical to recoup those funds from the minority for reinvestment, especially if they are subjected to personal income taxation in respect of that distribution under Canadian or foreign tax laws. Thirdly, the disposition of the CFA may not provide the CRIC with property that it can distribute to its shareholders (such as shares or debt which is not publicly traded).

Under the current rules, if the proceeds from the disposition of CFA are not distributed but are directly deployed by CRIC to make an investment in another subject corporation, the $80 million reduced PUC would be reduced by a further $25 million to $55 million notwithstanding that the CRIC has increased its investment in foreign affiliates by only $5 million. If the second investment is sold giving rise to $25 million of proceeds which are again deployed to make an investment in another subject corporation, the PUC will be reduced to $30 million. If the proceeds are reinvested in Canadian assets, the PUC would not be further reduced but it would not ever be reinstated. In that sense, the rules give rise to a bias against reinvestment, including reinvestment in Canadian assets.

An automatic PUC reinstatement rule will require some additional consideration. For example, if an investment is only partially disposed of, only part of the PUC should be restored. Consequently, we suggest that the PUC reinstatement be limited to the lesser of (i) that proportion of the PUC reduction made in respect of the investment that the fair market value ("FMV") of the part disposed of is of the total FMV of the particular investment at the time of disposition and (ii) the FMV of the part disposed of at the time of disposition. Thus, returning to the example above, if CRIC sold 25% of the initial $20 million investment for $10 million, $5 million of PUC would be restored (being 25% of the initial $20 million PUC reduction) but, if it sold 25% of the investment for $4 million, only $4 million of the PUC would be restored.

Another source of complexity may arise because a particular investment may result in reductions of PUC of more than one class of shares of a corporation and of shares of classes of more than one corporation. The PUC offset rule requires the PUC reduction to be applied to maximize the reduction of cross-border PUC. One approach to the PUC reinstatement rule might be to restore PUC in the same order as it was reduced. In our view, that approach has the benefit of simplicity and fairness. Nevertheless, this is another aspect of the August Proposals, and of our recommendations thereon, which requires further consideration and which we would appreciate discussing with you in greater detail.

Recommendation

In our view, a more appropriate result would be to reinstate the PUC to the same extent that it would be reinstated if the proceeds, dividend or qualifying return of capital were distributed to shareholders as a distribution of capital and reinvested by those shareholders. Such reinstated PUC would be available (i) to return capital to shareholders; (ii) to be reduced under section 212.3 as a consequence of a subsequent investment in a subject corporation; or (iii) as capital for the thin capitalization provisions, depending on the circumstances. We recognize that this automatic PUC reinstatement will potentially result in some complexity but do not believe that any such complexity justifies maintaining the status quo.

b. More Technical Changes

We recognize that the changes necessary to implement our first recommendation may take some time or may not be viewed as appropriate by Finance. In either event, we recommend that some clarifying changes be made to subsection (9) as described below.

Subsection 212.3(9)

Subsection (9) only permits a reinstatement of the PUC of the particular class of shares that was the subject of a reduction of PUC by virtue of paragraph (2)(b) or subsection (7). There is no provision to permit the PUC to be restored if another class of shares has been substituted for the particular class notwithstanding that the reduced PUC is reflected in the substituted class. There is no reason to preclude the reinstatement of the PUC simply because there has been a reorganization of the relevant corporation or a reorganization of its capital. We recommend that the subsection (9) be amended by introducing a provision that would accommodate share exchanges. A model for such rule might be subsection 112(7).

Recommendation

Amend section 212.3 to add a new subsection (26) that would accommodate share exchanges in a variety of circumstances, including where a share of a particular class has been acquired in exchange for another share (of the same or a different corporation) in a transaction to which section 51, 85, 85.1, 86 or 87 applies, or would have applied were the old share held as capital property.

The application of such a share exchange rule would have to be coordinated with the application of subsection (8), as well as with the application of section 212.1.

Paragraph 212.3(9)(b)

Where subsection (9) applies, the reinstatement of PUC is effective immediately before the PUC is reduced by virtue of the distribution or redemption – the time at which it is reduced being the subsequent time. Paragraph (9)(b) contains one of the upper limits on the amount of the PUC that that may be reinstated, the purpose of which is to ensure that the total amount reinstated

does not exceed the amount by which the PUC was reduced, taking into account any prior reinstatements. The operative words are as follows:

> (b) the amount, if any, by which
>
> > (i) the total of all amounts each of which is required, before the subsequent time, by paragraph (2)(*b*) or subsection (7) to be deducted, in respect of the investment, in computing the paid-up capital in respect of the class
>
> exceeds
>
> > (ii) the total of all amounts required under this subsection to be added, in respect of the investment, to the paid-up capital of the class before the subsequent time, and

Because the amount described in (ii) includes all amounts added by subsection (9) before the subsequent time, and subsection (9) itself adds the amount to PUC of the class immediately before the subsequent time, the language results in any amount to be added being immediately deducted in determining what may be added. We believe this may be remedied by adding "before the time that is immediately" as a modifier.

<u>Recommendation</u>

Amend subparagraph (9)(b)(ii) to read as follows:

> (ii) the total of all amounts required under this subsection to be added, in respect of the investment, to the paid-up capital of the class <u>before the time that is immediately</u> before the subsequent time

Paragraph 212.3(9)(c)

Subsection (9) is premised on a reduction of PUC occurring because of a distribution of property by a particular corporation (in contrast to a reduction of PUC that occurs because shareholders resolve to reduce PUC without a distribution). Paragraph (9)(c) restricts the source of the amounts distributed on a reduction of capital that will result in the PUC being reinstated.

Subparagraph (c)(i) is concerned with distributions by the particular corporation of shares of the capital stock of the subject corporation (the "subject shares") or shares of the capital stock of a foreign affiliate of the particular corporation that were substituted for the subject shares. We have several comments on this provision.

First, for clarity, the term "substituted shares", which is used elsewhere in subsection (9) and which we understand to refer to shares of the capital stock of a foreign affiliate of the particular corporation that were substituted for the subject shares, should be defined.

<u>Recommendation</u>

We recommend that this can be accomplished by simply adding "(in this paragraph referred to as "the substituted shares")" at the end of the opening phrase of subparagraph (9)(c)(i).

10(f) Shares

Secondly, although paragraph (2)(b) and subsections (7) and (9) apply in respect of an investment described in paragraph (10)(f) – being the acquisition of shares of a corporation resident in Canada that meets certain conditions ("10(f) shares"), subparagraph (9)(c)(i) does not accommodate a distribution of such shares. It applies to reinstate PUC only when the property distributed is "shares of the capital stock of the subject corporation" which, by definition, are shares of a foreign affiliate. Because it is an investment in 10(f) shares that results in the reduction of PUC, the distribution of those shares (or shares substituted therefor), to the extent such distribution is an indirect distribution of the shares of the subject corporation(s) that resulted in the reduction of PUC, should also result in a reinstatement of the PUC.

Recommendation

We recommend that subsection (9) be amended so that it applies to indirect distributions of shares of subject corporations through the direct distribution of shares of a corporation resident in Canada described in (10)(f).

Subparagraph 212.3(9)(c)(ii)

Subparagraph (9)(c)(ii) applies where the property distributed on the reduction of capital is not shares of the subject corporation. In such circumstances the limit on the PUC reinstatement is the amount equal to the FMV of property that the particular corporation demonstrates it has received directly or indirectly either as proceeds from the disposition of the subject shares (or the substituted shares) or as a dividend or qualifying return of capital in respect of a class of subject shares (or substituted shares). We have several comments on this provision.

If the subject shares are owned by a lower tier corporation, it is only that lower-tier corporation that can receive an amount *as* proceeds of disposition of those shares or *as* a dividend or qualifying return of capital in respect of those shares. While we acknowledge that clause (A) refers to property the particular corporation has received *directly or indirectly*, in our view, only the owner of the subject shares can receive an amount as proceeds of disposition, a dividend or a return of capital. At best, any amount received directly by a particular corporation that is not the CRIC holding the investment in the subject corporation may be considered to be *derived* from such proceeds of disposition, dividend or qualifying return of capital, unless it is appropriate to interpret the phrase “it has received directly or indirectly” broadly so that any amount received by a corporation in which the particular corporation has an interest should be regarded as having been received by the particular corporation “indirectly”. A similar concern relates to the amounts referenced in subclause (III): amounts received directly or indirectly *as* a repayment or *as* proceeds from the disposition or *as* interest.

Moreover, where the PUC offset affected the shares of a QSC and the QSC holds less than 100% of the CRIC (assume it held only 51%), even a distribution by the CRIC to its shareholders may not result in the QSC receiving an amount equal to the amount of the

previous PUC reduction (assuming the previous PUC reduction was equal to the amount of the investment by the CRIC), which could permanently impair the reinstatement for that QSC.

As described above, we believe that the PUC should be reinstated immediately upon disposition of an investment or payment of a dividend or qualifying return of capital. However, if Finance does not accept that recommendation, in our view, it should be sufficient for the particular corporation that makes the required distribution – for example, a QSC – to demonstrate that the CRIC or a corporation resident in Canada that does not deal at arm's length with the particular corporation received the relevant dividend, return of capital, proceeds of disposition or interest payment or debt repayment, rather than having to demonstrate that the same was received by itself.

In addition, the 180-day period for making any such required distribution should be extended, particularly in the context of a disposition. Under the current formulation of the rule, no PUC is reinstated until immediately before the amount is distributed on a reduction of capital. As a result, a delay between the receipt of the relevant funds as proceeds, a dividend, return of capital or interest payment or debt repayment, and the distribution of those funds to the shareholders may undermine the operation of the PUC reinstatement rule. Particularly in the case of a disposition, the receipt of proceeds may be delayed beyond 6 months. For example, a portion of the proceeds may be escrowed for a period of time following closing, and while the matter is uncertain it could be argued that the escrow arrangement results in the receipt of such proceeds and thus starts the clock in relation to the 180-day requirement. If our recommendation regarding automatic PUC reinstatement on a disposition of an investment is not accepted, we submit that the 180-day period in paragraph (9)(c)(ii) should be extended to at least 24 months.

As a minor technical issue, we note that the language in subclause (c)(ii)(A)(II) used with respect the subject shares and the substituted shares is inconsistent. In the case of subject shares the amount must be received as a dividend or qualifying return of capital, within the meaning assigned by subsection 90(3). In the case of substituted shares, the amount must be received as a dividend or reduction of PUC. We assume this is an oversight and recommend in both cases the reference should be to a dividend, qualifying return of capital or on a reduction of paid-up capital (to accommodate redemptions).

Subclause (III) is intended to permit a PUC reinstatement where the PUC has been reduced because the CRIC acquired a debt obligation or an amount became owing to the CRIC. The PUC is reinstated only where there is a repayment of the debt or proceeds of disposition. If the debt obligation is converted to shares in a transaction that does not give rise to a new investment (because the exception in subsection (18) applies), in our view the PUC should be restored on a subsequent disposition of the shares to the same extent that it would have been had the shares been acquired at the outset.

As a minor technical issue, we find the phrase "in connection with the investment" in subclause (III) 1. confusing and recommend it be deleted. In our view, given the only investments in clause (III) are debt obligations or amounts owing, the provision is clear without that phrase and the phrase only confuses the issue.

Recommendation

Thus, we recommend subparagraph (9)(c)(ii) be redrafted to read as follows:

> (ii) is equal to the fair market value of property that the particular corporation demonstrates
>
> > (A) has been received at a particular time, that is after the investment time and before the subsequent time [or no more than 24 months before the subsequent time],[1] by a corporation resident in Canada with which the particular corporation was not dealing at arm's length at the particular time
> >
> > > (I) as proceeds of disposition of the subject shares, or as the portion of the proceeds from the disposition of the substituted shares that may reasonably be considered to relate to the subject shares, or
> > >
> > > (II) as a dividend, a reduction of paid-up capital or a qualifying return of capital, within the meaning assigned by subsection 90(3), in respect of a class of subject shares, or the portion of a dividend, reduction of paid-up capital or qualifying return of capital, within the meaning assigned by subsection 90(3), in respect of a class of substituted shares that may reasonably be considered to relate to the subject shares, or
> > >
> > > (III) if the investment is described in paragraph (10)(*c*) or (*d*) or subparagraph (10)(*e*)(i),
> > >
> > > > 1. as a repayment of or as proceeds from the disposition of the debt obligation, or amount owing, or
> > > >
> > > > 2. as interest on the debt obligation or amount owing,
> > >
> > > provided that if such investment was exchanged for shares of a subject corporation before the particular time, the shares of the subject corporation so acquired shall, for the purposes of this subsection, be deemed, and the debt obligation or amount owing exchanged for such shares shall be deemed not, to be the investment in the subject corporation made by a CRIC that resulted in the reduction of paid-up capital in respect of the class of shares of the capital stock of the particular corporation,

5. Reorganizations

a. Non-Arm's Length Acquisitions

Clauses (18)(a)(i)(B) and (ii)(B), and (c)(i)(B) and (c)(ii)(B), require that the relevant corporations did not have an arm's length relationship at any time that is in the period during which the series of transactions or events that includes the making of the investment occurs and that is before the investment time. This condition effectively precludes reorganizations that occur in the post-

[1] The portion in square brackets is there to reflect our alternative recommendation, not our preferred approach.

acquisition context except if the much narrower rule in subsection (22) is applicable. Thus, while in principle a post-acquisition reorganization is not intended to give rise to the application of subsection (2), in practice this may occur because it may not be feasible to structure the reorganization in a manner that complies with subsection (22) – for example, a horizontal amalgamation.

We believe that this condition should be eliminated. While we understand that the rules are designed to capture not only direct investments but also indirect investments – the latter objective is already covered by paragraph (10)(f). If paragraph (10)(f) applies to the acquisition of the shares of a corporation resident in Canada by another corporation resident in Canada, then there should not be a second application where the acquired corporation is amalgamated with another related corporation, or otherwise disposes of an investment to another related corporation, even if subsection (22) is not applicable. Similarly, if paragraph (10)(f) does not apply to the acquisition of the shares of a corporation resident in Canada by another corporation resident in Canada, then that should be the end of the matter and subsection (2) should not apply where the acquired corporation is amalgamated with another related corporation, or otherwise disposes of an investment to another related corporation, even if subsection (22) is not applicable.

Where the initial transaction is a horizontal amalgamation, that transaction could itself trigger the application of subsection (2) because this transaction would not in any event meet the condition in clauses (18)(a)(ii)(A) or (c)(ii)(A).

Recommendation

We recommend that the requirements in clauses (18)(a)(i)(B) and (ii)(B), and (c)(i)(B) and (c)(ii)(B), that require that the relevant corporations did not have an arm's length relationship at any time that is in the period during which the series of transactions or events that includes the making of the investment occurs and that is before the investment time, be deleted.

We understand that a comfort letter has been issued in relation to these requirements (dated July 9, 2013), and we believe our recommendation is consistent with the principles reflected in that comfort letter.

b. Sequential Investments

Another aspect of subsection (18) that can give rise to multiple applications of subsection (2) is the requirement, in clause (18)(c)(v)(A), that the two relevant investments "occur within 30 days of each other", in addition to being "part of the same series of transactions or events" as required by clause (18)(c)(v)(B). We submit that this requirement can give rise to significant hardship where it is impractical or impossible for money raised by the first investment to be deployed in the second investment within 30 days. We submit that this requirement should be deleted and that it should be sufficient for the two investments to be made as "part of the same series of transactions or events". If the "series" standard is sufficient to connect an investment with the acquisition of control by the parent, then it seems difficult to understand why it is not sufficient to connect the two sequential investments for the purpose of eliminating duplicative application of the rules.

Duplication of investments can also arise where a paragraph (10)(f) investment is made after a related direct investment in a subject corporation. Pursuant to subsection (1), the rules will apply to an investment made by a CRIC in a subject corporation where that CRIC becomes, after the investment time and as part of a transaction or event or series of transactions or events that includes the making of the investment, controlled by a non-resident corporation. Unless the safe harbour in paragraph (1)(b) applies, this investment will result either in a deemed dividend or PUC reduction at the dividend time. However, if the transaction pursuant to which the non-resident corporation acquires control of the CRIC is itself an investment described in paragraph (10)(f), the rules will effectively apply twice. For example, assume that a non-resident corporation has a right to acquire all of the shares of a Canadian corporation (Canco), and before that acquisition is completed, Canco subscribes for additional shares of a foreign affiliate as part of the same series of transactions as the acquisition of control of Canco by the non-resident corporation. The acquisition by the non-resident corporation is later completed, with that corporation using a Canadian acquisition company (Bidco) to acquire all of the shares of Canco. If Canco is a corporation described in paragraph (10)(f), the acquisition of the Canco shares by Bidco will also result in the application of the rules and the deemed dividend or PUC reduction will reflect the same value as the investment by Canco in the foreign affiliate. One of these two investments should not be subject to the rules, as this would result in duplication.

Recommendation

We recommend that the requirement, in clause (18)(c)(v)(A), that the two relevant investments "occur within 30 days of each other", be deleted.

In addition, we recommend that a rule be added to provide that an earlier investment in a subject corporation by a CRIC not be considered to be an investment for purposes of the rules where paragraph (10)(f) applies to a later investment in the shares of a CRIC by a non-resident corporation that would be the parent in respect of both investments. A provision along the following lines could be added in this regard:

> For the purposes of subsection (10), an investment in a subject corporation made by a CRIC at an investment time shall not include a transaction that would otherwise be described in subsection (10) where
>
> (i) the CRIC is not controlled by the parent at the investment time, and
>
> (ii) the CRIC becomes, after the investment time and as part of a transaction or event or series of transactions or events that includes the making of the investment, controlled by the parent because of an acquisition described in paragraph (10)(f); and
>
> (iii) the amount of the investment is subject to paragraph (2)(a) because paragraph (10)(f) applied when the parent acquired control of the CRIC.

c. Canadian Investments and Similar Situations

Another problem under the existing rules not addressed by the August Proposals is the possibility that they can apply in respect of what is purely an incremental Canadian investment. For example, assume the non-resident parent owns Canco 1 and Canco 1 owns Canco 2, which

is a (10)(f) corporation. If parent invests $100 in Canco 1 which Canco 1 invests in Canco 2, Canco 1's investment will be a paragraph (10)(f) investment even if Canco 2 uses the funds to make a Canadian investment unless Canco 1's investment is saved by subsection (18). That result seems inappropriate. Canco 1's investment in Canco 2 does not result in any incremental investment in a subject corporation because Canco 2's incremental assets are not an investment in a subject corporation.

The same is true where Canco 2 uses the funds to repay indebtedness rather than acquiring additional Canadian assets – there is no incremental investment in a subject corporation.

This rule should apply only to the extent that Canco 1's investment in Canco 2 increases the parent's equity percentage (or a similar measure of equity interest) in any subject corporation.[2] Thus, in the context of a wholly-owned group, or where the parent group (i.e., Canco 1) makes proportionate incremental investments into Canco 2, this result should not arise.

Recommendation

We recommend that similar relief be provided where the paragraph (10)(f) investment (i.e., the direct investment in the other corporation resident in Canada) cannot reasonably be considered to increase the parent's equity percentage (or a similar measure of equity interest) in a subject corporation.

d. Debt Conversions

The August Proposals would amend paragraph (18)(d) to restrict its application in various respects – in particular, to limit its application to a "bond, debenture or note" where subsection 51(1) would apply to the exchange if the terms of the bond, debenture or note conferred on the holder the right to make the exchange. We submit that this formulation would be overly restrictive, in that there are many forms of indebtedness that may not constitute a "bond, debenture or note". We submit that this paragraph should apply to any form of indebtedness, in order to better parallel paragraphs (10)(c) and (d) and thus to avoid duplicative application of subsection (2).

Recommendation

We recommend that paragraph (18)(d) be worded as follows:

> (d) the investment is an acquisition of shares of the capital stock of the subject corporation that is described in paragraph (10)(a), or an indirect acquisition referred to in paragraph (10)(f) that results from a direct acquisition of shares of the capital stock of another corporation resident in Canada, where the shares are acquired by the CRIC

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[2]. In this regard, we note that the term "equity percentage" depends on the definition of "direct equity percentage" (both as defined in subsection 95(4)), which is based on the highest percentage of any particular class of the relevant corporation that is held by the particular person, which may not be an appropriate measure of equity interest for this purpose.

from the corporation in exchange for indebtedness of the corporation and no consideration other than the shares is received by the taxpayer for the indebtedness;

This language would replicate the conditions in subsection 51(1) except that the indebtedness would not have to be capital property, would not have to be represented by a "bond, debenture or note", and would not have terms that confer the right to exchange the indebtedness. This would preclude the application of the rule to circumstances where the shares of one corporation are acquired in exchange for indebtedness of another corporation, while being broad enough to avoid duplicative application of subsection (2).

e. Deemed Dispositions and Reacquisitions

Various provisions of the Act provide for the deemed disposition and reacquisition of property by a corporation resident in Canada. For example, proposed section 80.6 can apply to deem a corporation to have disposed of and to have reacquired a property where the corporation enters into a "synthetic disposition arrangement". We believe that the application of such rules may result in an investment described in subsection (10). However, it is our view that these rules do not provide for any deemed amount contemplated by paragraph (2)(a), in that they do not provide for any deemed transfer of property or other relevant amount described in paragraph (2)(a). Nevertheless, it would be preferable in our view to clarify the matter by providing, for greater certainty, that subsection (2) does not apply to an investment described in subsection (10) that arises by virtue of a deemed acquisition of property by a CRIC following a deemed disposition of the property by the CRIC because of the application of any provision in the Act to that effect.

Recommendation

We recommend that a rule be introduced, perhaps in subsection (18), that provides, for greater certainty, that subsection (2) does not apply to an investment described in subsection (10) that arises by virtue of a deemed acquisition of property by a CRIC following a deemed disposition of the property by the CRIC because of the application of any provision in the Act to that effect.

6. Indirect Financing – Subsection 212.3(24)

Subsection (24) provides that subsection (2) will not apply to an investment made in certain foreign affiliates that make a loan to an affiliate that qualifies for the "closely connected business" exception in subsection (16). The borrower affiliate must be a controlled foreign affiliate within the meaning of section 17 and must use the borrowed money in an active business carried on by it in the country in which it is resident.

The August Proposals would expand this exception to loans that give rise to income that is included in the active business income of the lender under subparagraph 95(2)(a)(ii) (or would be so included if there were income from the loan). This change will allow the borrower to use the proceeds of the loan for other purposes, including the acquisition of shares of another foreign affiliate that qualify as excluded property.

The proposed change is welcome but in our view does not go far enough. For example, the subsection does not allow the funding affiliate to acquire a debt of the closely connected affiliate. However, in our view, a much broader rule is required that applies to all entities earning income to which paragraph 95(2)(a) applies. If a CRIC is eligible for the "closely connected business" exception in respect of a foreign affiliate or group of foreign affiliates, it should be able to invest in special purpose foreign affiliates that relate to the business of that foreign affiliate or group of foreign affiliates without restriction (i.e. in the same manner as any Canadian multinational). It should be able to establish such foreign affiliates to earn deemed active business income relating to the business of the closely connected affiliate in any manner provided for in paragraph 95(2)(a).

Recommendation

Provide an exception to subsection (2) for investments in a subject corporation that are used by the subject corporation for the purpose of earning income relating to the business of a closely connected affiliate within the meaning of subparagraph 95(2)(a)(i), income paid or payable from the closely connected affiliate within the meaning of subparagraph 95(2)(a)(ii) and so on.

7. Preferred Shares – Subsection 212.3(19)

Subsection (19) provides that the "closely connected business exception" in subsection (16) and the reorganization exceptions in subsection (18) do not apply if a CRIC acquires shares of a subject corporation that do not fully participate in the profits of the corporation or increase in value of the corporation (generally referred to as preferred shares). In addition, the new safe harbour rule in paragraph (1)(b) does not apply if the shares acquired are preferred shares. An exception is provided for subsidiary wholly-owned corporations or subject corporations that would be subsidiary wholly-owned corporations if the CRIC owned all the shares of the subject corporation owned by the CRIC, a corporation resident in Canada that is a subsidiary wholly-owned corporation of the CRIC, and a corporation resident in Canada of which the CRIC is a subsidiary wholly-owned corporation.

In our view, the exception is unduly restrictive and, in determining subsidiary wholly-owned corporation status, should take into account those shares of the subject corporation owned by foreign affiliates of the CRIC or related Canadian residents. If the CRIC or a Canadian wholly-owned group collectively owns directly or indirectly all of the shares of a subject corporation, there should be no restriction on the acquisition of preferred shares of the subject corporation, even if the subject corporation is held by a wholly-owned foreign affiliate or affiliates rather than directly by the Canadian group.

Recommendation

Add the following after paragraph (19)(c):

> (d) a foreign affiliate of the CRIC or a person referred to in paragraph (b) or (c) that would be a subsidiary wholly-owned corporation of the CRIC if the CRIC owned all of the

shares of the foreign affiliate owned by the CRIC or a person referred to in paragraph (b) or (c), and

(e) a foreign affiliate of the CRIC or a person referred to in paragraph (b) or (c) that would be a subsidiary wholly-owned corporation of the CRIC if the CRIC owned all the shares of the foreign affiliate owned by the CRIC or by persons referred to in paragraphs (b) to (d).

8. Deemed Control by a Corporation – Paragraph 212.3(15)(b)

This new rule deems a corporation to be controlled by another corporation in certain circumstances involving control by a "related group". It appears to be essentially an anti-avoidance rule, which, according to the Explanatory Notes, "ensures that subsection 212.3(2) cannot be avoided" by holding shares through multiple related corporations no one of which itself has voting control.

While the application of this rule in some fact patterns seems reasonable, there are also circumstances where the rule may inappropriately expand the scope of subsection (2).

The text of the rule provides that it may apply where a "related group" of non-resident corporations "in in a position to control a corporation". A "related group" is defined in subsection 251(4) as a "group of persons each member of which is related to every other member of the group". In effect, therefore, the "related person" rules in section 251 must be considered in determining whether a related group exists.

Related Group "in a Position to Control"

Consider a situation in which three otherwise unrelated and arm's length non-resident corporations (A, B and C) each own one-third of the shares of CRIC. Suppose A, B and C have negotiated a *bona fide* shareholders agreement governing their ownership of CRIC. Suppose the shareholders agreement includes contingent rights to acquire shares, to control voting rights in respect of shares, or to otherwise obtain rights referred to in paragraph 251(5)(b). In that situation, each of A, B and C would be considered "related" to CRIC by virtue of paragraph 251(5)(b). Furthermore, by virtue of subsection 251(3), since each of A, B and C is related to CRIC, each of them is deemed to be related to the other. It seems to follow that A, B and C technically constitute a "related group".

Applying proposed paragraph (15)(b), a determination must then be made as to whether or not this related group is "in a position to control" CRIC. This phrase, which is also used in paragraph 251(5)(a), is somewhat ambiguous, particularly in the context of a related group where the related-ness of the members of the group derives from the application of other deeming rules. It seems there is at least a possibility that in order to determine whether a related group is "in a position to control", one simply adds up the voting rights attached to the shares owned by the members of that group, which in this case would clearly exceed 50%. If this is the correct interpretation, then the rules would apply, with the "parent" being one of A, B or C, as agreed by the parties or as determined by the Minister.

We believe that in a situation such as this, it is simply inappropriate for the rules to apply. The rules are clearly intended to apply only where there is a controlling non-resident corporate shareholder. This is not a case of a single, otherwise controlling shareholder splitting ownership to avoid the rule.

There are different ways of addressing this problem. The most direct and, we believe, sensible approach would be to provide that in determining whether a group of persons is a related group for purposes of paragraph (15)(b), related-ness should be determined without reference to paragraph 251(5)(b) rights. This would confine the rule to situations in which corporations that are related in a more fundamental way could otherwise have circumvented the rules.

Related Group Controlled by Individual/Trust with Small Economic Interest and PE Funds

There are other situations in which the new rule could significantly, and we believe inappropriately, expand the reach of the rules.

Consider a situation where a non-resident individual or trust manages investment funds for third party investors. The investment funds are structured as partnerships of which the general partner (which has a nominal economic interest but, through the partnership agreement, voting control) is a non-resident company such as a US limited liability company ("LLC"). The controlling individual or trust has a small economic interest in the funds but controls the general partners. Each of the funds operates in accordance with its investment mandate, and these mandates differ among the investment funds. Suppose the investment funds collectively own more than 50% of the voting shares of CRIC.

In analyzing this situation, the ownership attribution rules in subsection (25) must be considered. These rules effectively attribute to a taxpayer ownership of shares owned by the taxpayer through a partnership based on the FMV of the taxpayer's partnership interest as a percentage of the FMV of all partnership interests. On this basis, it seems at least arguable that the general partners, had they been a single person, would not "control" the CRIC. But would the general partners be regarded as a related group that is "in a position to control" – presumably on the basis that they actually have, collectively, and subject to the constraints of their respective partnership agreements and investment mandates, the ability to control the board of CRIC?

This situation is obviously entirely different from that at which the rules are targeted if it is targeted at avoidance situations. We believe the new deeming rule should be narrowed so that it does not apply in this type of situation. This could be done by confining its application to a situation in which the corporations that are members of the related group have not only sufficient shares to be "in a position to control" the CRIC, but also a meaningful economic interest in CRIC.

This raises the more general issue of the treatment of investment funds, including private equity ("PE") funds, that are structured as partnerships the general partner of which happens to be an entity that is considered a corporation for Canadian tax purposes. It is common for the general partner of such a fund to be a US LLC – as opposed to a US limited partnership – due to the more certain liability shield provided by such a company. It is also common for the general partner to contribute little or no equity, but to have the ability to "earn" a "carried interest" in the partnership, typically capped at 20%. In the fairly typical case of such a fund with diverse

institutional investors, such as pension funds and foreign governmental entities, it would be normal for no single non-resident corporation (or related group) to be considered to own more than 50% of the voting shares of the CRIC, applying the rules in section 212.3, including the ownership attribution rule in subsection (25). However, there is a meaningful lack of clarity as to whether the general partner – if it is, as is typical, organized as an LLC – would be considered to "control" the CRIC by virtue of its control rights arising (though constrained) under the partnership agreement.

In the Explanatory Notes that accompanied Bill C-45, under subsection (16) – the "more closely connected" exception – it is at least implied that the rules could be engaged in the case of a typical PE fund. This is not explained, but the presence of this discussion creates uncertainty as to whether the general partner in a typical PE fund might be regarded as a non-resident corporation that "controls" the CRIC by virtue of its voting entitlements arising under the partnership agreement.

We believe there is a compelling case for refining the scope of the rule so that it clearly does not apply in the case of a CRIC that is controlled by a typical PE fund or other investor that happens to be organized as a corporation but which has a sufficiently low economic interest. We would, in particular, suggest that if the shares of the CRIC owned (or deemed to be owned applying the rules in section 212.3 including subsection (25)) have a FMV that is less than 25% of the total FMV of all issued shares of the CRIC, then the particular non-resident corporation would not be considered to control the CRIC. The 25% threshold is suggested by the proposed wording for paragraph (1)(b), and seems to reasonably exclude situations that are in fact quite different from the fact pattern at which the rules are aimed.

Recommendation

We recommend that:

(1) in determining whether a group of persons is a related group for purposes of paragraph (15)(b), related-ness should be determined without reference to paragraph 251(5)(b) rights,

(2) a particular non-resident corporation should be considered to not control a CRIC where the shares of the CRIC owned (or deemed to be owned applying the rules in section 212.3 including subsection (25)) by the non-resident corporation have a FMV that is less than 25% of the total FMV of all issued shares of the CRIC, if that control arises by virtue only of the non-resident corporation's fiduciary duties and capacity as the general partner or trustee of a collective investment vehicle organized as a partnership or trust.

9. Immigration and Emigration

a. Immigration

Paragraph 128.1(1)(c.3) sets out a companion rule for situations involving an immigrating corporation that holds investments in non-resident corporations. This regime, however, is inconsistent with section 212.3 in that it does not contemplate the possibility of the immigrating

corporation making a PLOI election with respect to any indebtedness of a subject corporation it may hold at the time of its immigration.

Recommendation

We recommend that subclause (B)(II) of the description of A in subparagraph 128.1(1)(c.3)(i) be amended to exclude a PLOI, and worded as follows: "an amount owing by the subject affiliate to the taxpayer at the particular time, other than an amount that is a pertinent loan or indebtedness (as defined in subsection 212.3(11) immediately after the particular time".

b. Emigration

Subsection 219.1(3) sets out the conditions for the application of subsection 219.1(4), which is intended to provide for a PUC reinstatement where a CRIC emigrates from Canada having previously suffered a PUC reduction by virtue of paragraph 212.3(2)(b) or (7). We are concerned that these conditions are overly restrictive. In particular, under paragraph 219.1(3)(c), it is a condition that "subsection 212.3(9) has not applied in respect of any reduction of the paid-up capital in respect of a class of shares of the capital stock of the corporation or a specified predecessor corporation (as defined in subsection 95(1)) of the corporation". This condition is too restrictive because a single dollar of previous reinstatement under subsection 212.3(9) would completely preclude a reinstatement under subsection 219.1(4). This does not seem appropriate, and is not consistent with subsection 212.3(9) which reduces subsequent reinstatements only by the amount of previous reinstatements, in order to prevent duplicative reinstatements.

Recommendation

We recommend that the condition in paragraph 219.1(3)(c) be deleted and instead that a dollar-for-dollar limitation be incorporated into subsection 219.1(4) along the lines of the limitation in paragraph 212.3(9)(b).