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

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October 8, 2004

Mr. Brian Ernewein
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada
17th Floor, East Tower,
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Dear Mr. Ernewein:

Re: February 27, 2004 Draft Legislation (the "Draft Legislation")-- Proposed Amendments to the Foreign Affiliate Rules

We would like to first of all thank you for taking the time to meet with us on September 27, 2004, on the occasion of the Annual Conference of the Canadian Tax Foundation in Toronto. We appreciate your receptiveness to the process of discussing outstanding legislative issues with us from time to time.

Among the various matters discussed at that meeting, we noted our continuing concerns with respect to certain aspects of the proposed amendments to the foreign affiliate rules. While many of the proposed amendments are technical and relieving in nature, others seem to introduce restrictive – and, in some cases, unduly burdensome – departures from current rules and underlying principles. Moreover, we noted during the meeting that, in our view, while many of the proposed amendments would seem to be refined enough at this point to merit proceeding forward to the Technical Bill stage, certain of the proposals, as currently structured or drafted, would in many cases appear to be ineffective, overly disruptive of the scheme of the Act and Regulations in this area, and/or fiscally punitive. In particular, we note the following principal areas of concern:

- The proposed amendments with respect to "internal dispositions" would operate on the basis of a "suspended income and gains" mechanism, the introduction of which would in our view result in numerous anomalies in the distribution of economic values and tax attributes within a chain of foreign affiliates. In addition, we are aware of examples where this approach could result in the punitive taxation as FAPI of gains which accrued on excluded property, as well as in the complete ineffectiveness of the proposed amendments. These anomalies would in our view arise because of structural aspects of the approach being adopted, rather than because of drafting issues.

- The proposed amendments with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates would also appear to give rise to anomalous consequences in many cases, as a result of certain structural aspects of their formulation. In this context, we have seen examples of transactions that would result in the imposition of taxation under the Act in circumstances involving no more than a simple corporate combination or other reorganization that does not in any substantive way alter the indirect economic relationship between the relevant assets or surplus and the relevant taxpayer(s), as well as examples where radically different consequences would arise under the Act or the Regulations depending on whether a merger rather than a liquidation or other reorganization transaction is implemented even though the exact same corporate and commercial result would be achieved either way.

- The proposed amendments with respect to adjustments to be made to the various surplus and other accounts of a foreign affiliate as a result of the application of the subsection 93(1) deemed dividend rules, and in the context of certain changes to a relevant taxpayer's surplus entitlement percentage, would also appear to result in anomalous consequences in certain cases, including the over-attribution of underlying deficits and, more generally, the "scrambling" of surplus accounts. In addition, these measures would appear to introduce inordinate uncertainty, complexity and administrative and compliance costs into the system.

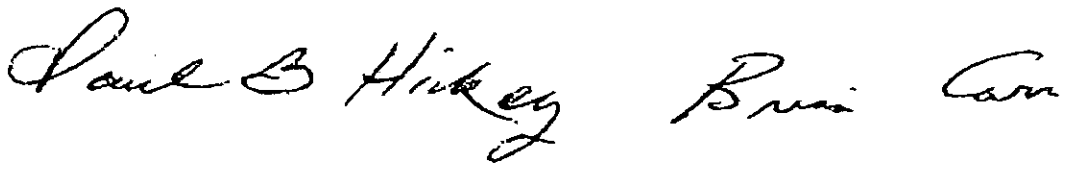
We believe that an alternative approach could be devised for "internal dispositions" that could address the concerns of Finance in this regard in a manner that would not give rise to such anomalies. Similarly, we believe that the concerns of Finance with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates could be addressed in a more conceptually coherent manner, and more consistently with certain of the fundamental principles that underlie the scheme of the Act and Regulations in this area. We also believe that Finance's concerns with respect to the surplus account adjustment rules could be addressed in a more efficient manner, that would not disrupt the relationship between tax attributes and economic values, and therefore would be more consistent with the underlying purpose of these rules.

Although we have had certain initial and informal discussions and correspondence with officials of your Department to this effect, we believe that additional representations are warranted in the circumstances. We are quite busy preparing a relatively comprehensive submission on the foreign affiliate proposals that covers a broad range of relevant technical and policy considerations, as well as a separate submission on the other (non-foreign affiliate) aspects of the Draft Legislation. Both should be finalized in the coming few weeks.

At the meeting on September 27 we suggested the possibility of severing certain aspects of the proposed amendments from the coming Technical Bill, such that they may be considered in greater depth, while the balance of the proposals proceed through the legislative process. We would strongly encourage you to adopt this approach, and would recommend for your consideration in this regard severing the three issue areas described above.

We would be pleased to elaborate on our thoughts in this regard, including with respect to transitional issues, should you consider it to be advisable to entertain this possibility further.

Yours truly,



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January 20, 2006

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Dear Mr. Ernewein:

Additional Submission—Proposed Amendments to Foreign Affiliate Rules in February 27, 2004 Draft Legislation (the "Draft Legislation")

We would like to first express our thanks to you and your colleagues for taking the time to meet once again with our Foreign Affiliate Subcommittee (the "Subcommittee") on October 3, 2005. At that meeting, the Subcommittee undertook to provide you with further comments on aspects of the Draft Legislation, and modifications thereto that are under consideration, relating to the treatment under the federal *Income Tax Act* (the "Act") and *Income Tax Regulations* (the "Regulations") of certain foreign affiliate ("FA") distributions. This submission, which contains these comments as well as comments on foreign exchange hedging arrangements, follows our previous submissions of November 3, 2004 and October 8, 2004 on the Draft Legislation and our September 18, 2003 submission on the earlier December 20, 2002 proposed amendments to the foreign affiliate rules.

This submission provides you with our comments with respect to the following three matters:

- ***Foreign Paid-Up Capital.*** The first matter is the basic question of whether or not the characterization of a FA distribution should be determined as a function of the FA's "foreign paid-up capital" ("FPUC"). In this regard, for the reasons set out below, the Joint Committee strongly recommends that the characterization of a FA distribution should not be determined as a function of the FA's FPUC. Rather, the character of a FA distribution should be determined as a function of the FA's underlying surplus accounts, in accordance with the scheme of the Regulations. That scheme, in our view, clearly reflects the principle that, in the FA context, unlike in the domestic context, the "default" treatment for corporate distributions is cost recovery treatment, except to the extent that there exists economic

appreciation reflecting earnings realized after FA status commences, translated into surplus accounts. In this context, FPUC and its domestic analogue, "paid-up capital" ("PUC"), are in our view largely immaterial and often inappropriate measures of the relevant amounts.

- ***FPUC Currency.*** The second matter is the question of which currency such FPUC should be maintained in, assuming such a concept should be introduced. In this regard, and on the basis that FPUC would be introduced as a means of achieving income-measurement objectives, it is our strong recommendation that FPUC should be maintained in the relevant shareholder's calculating currency –Canadian dollars in the case of a taxpayer resident in Canada (and, in certain situations, a FA).

- ***Hedging Arrangement Currency.*** The third matter arises in the context of the proposed amendments relating to foreign exchange hedging arrangements (e.g., proposed paragraph (c.1) of the definition of "excluded property" ("EP") in subsection 95(1), proposed subparagraph 95(2)(a)(vi), and proposed paragraph 95(2)(i)). In this context, we address the question of whether or not there should be any technical limitation on the currency to which a particular foreign exchange exposure (arising in some other currency) could be hedged, and strongly recommend that no such technical limitation be introduced.

We elaborate below on our comments with regard to each of these matters, and include an Appendix that illustrates the operation of our recommended approach.

Foreign Paid-Up Capital (FPUC)

We believe our Subcommittee's discussion with you of the FPUC concept would benefit from revisiting how it evolved, essentially as the measure of the amount (i.e., the cost, as we describe below) of a shareholder's investment in a FA. While PUC has certain connotations for the purposes of the Act, mostly concerning the taxation of Canadian resident corporations and their shareholders more or less on an integrated basis, we suggest and comment below that the same connotations are not typically or even systemically present or appropriate in relation to the taxation of FAs and their shareholders.

We suggest that the FPUC notion has evolved simply as a method for measuring the amount invested by a shareholder in a FA – in effect, as a proxy or measure for the tax-paid cost to a shareholder of FA shares, and in the case of an original investment to acquire treasury shares will align closely if not completely with the adjusted cost base (or "ACB") of those shares to the shareholder, determined in the shareholder's calculating currency. Moreover, as the present proposal for subsection 88(3) as it is developing evidently accepts and does or is expected to reflect, this is the case regardless of whether the invested amount is accounted for by the FA as legal share capital, contributed surplus, share premium or another manifestation of the invested amount. The problem, in our view, arises where the shareholder has in fact incurred or laid out *bona fide* tax-paid cost for FA shares that may not be reflected in its FPUC, or in legal capital reflecting an actual contribution – e.g., where the shareholder acquired the FA shares from another shareholder rather than from treasury, or where the relevant FA has undergone or participated in certain types of capital or other corporate or commercial reorganizations.

We recognize that, from the Department's perspective, this matter to some extent involves the belief that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain, even at the time of ultimate repatriation (i.e., "distributions" into Canada). However, while this principle has been reflected for some time in subsection 93(1.1), this provision has never applied with respect to situations of ultimate repatriation. Thus, to date, the principle that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain at the time of ultimate repatriation has not been reflected in the Act – and, according to our understanding, it is precisely this that the Department proposes to change. Nevertheless, it is also our understanding that this change would not involve the abandonment of the principle that the taxpayer should be permitted to recover its tax-paid investment before recognizing any further income. As a consequence, it would seem to us that these two principles would have to be reconciled appropriately in designing the relevant measure.

Suggested Adjusted Cost Base (ACB) Approach

In this submission, we propose an approach that achieves this objective by adopting ACB (a shareholder concept) rather than PUC (a corporate capital concept) as the best measure of the tax-paid amount invested by a shareholder that may be returned to it without further tax. We suggest that, as a matter of principle, tax-paid cost in this context includes not only the amount paid by a shareholder to subscribe for shares of the issuer, but as well any amounts paid to an unrelated party to acquire such shares. The same interests with respect to the ultimate actual taxation of inherent corporate value and shareholders in the context of the integrated taxation of corporate income, which are served by PUC in the domestic context, simply are not present when dealing with FAs. Indeed, the scheme of the Act and Regulations in this context clearly reflects the principle that an acquiring shareholder of FA shares does not inherit the FA's surplus history from the disposing shareholder, except in certain non-arm's length transfers or reorganizations contemplated by Regulation 5905. Thus, pre-acquisition surplus can and often does reflect what in law or otherwise would constitute corporate "retained earnings". Those pre-acquisition corporate retained earnings are never used in the FA context to determine the character and treatment of FA distributions, since pre-acquisition surplus distributions always give rise to cost recovery treatment for the purposes of the Act and Regulations.

It follows, in our view, that the appropriate measure of the tax-paid invested amount, in the FA context, is cost or ACB from the shareholder's perspective rather than retained earnings or legal capital from the corporation's perspective. To adopt a different approach, we suggest, would in many cases invite double or otherwise inappropriate taxation of the after-tax capital expended by a shareholder to acquire the shares. Thus, while our specific comments which follow proceed on the understanding, based on the Department's perspective, that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain, we believe it is equally important not to abandon the principle that the taxpayer should be permitted to recover its tax-paid investment before recognizing any further income.

Accordingly, assuming that the taxpayer should continue to be permitted to recover its tax-paid investment before recognizing any further income (and assuming that the measure of the taxpayer's investment should be ACB, and that the measure of a FA's relevant undistributed surplus should continue to be "attributed net surplus", as reflected in subsection 93(1.1)), and assuming further that the taxpayer should not be permitted to "convert" undistributed "taxable

surplus" into a capital gain, even at the time of ultimate repatriation, then it would seem to us that any measure introduced in this regard should be engaged only if and to the extent that a capital gain would otherwise arise. As a corollary, if no capital gain would otherwise arise, then it is obvious that the taxpayer would not be "converting" undistributed "taxable surplus" into a capital gain, so no deemed dividends should arise.

What follows from this logic, in our view, is that the Department should consider simply extending the scope of subsection 93(1.1) rather than introducing an additional and inconsistent regime that operates as a function of FPUC. It is submitted that such an extension would be sufficient to address the Department's concerns with respect to the "conversion" of undistributed "taxable surplus" into capital gains, and would be consistent with fundamental aspects of the scheme of the FA rules. For example, subsection 93(1.1) could be extended to circumstances in which the shares of a FA held by a taxpayer resident in Canada are either redeemed, acquired or cancelled by the FA (including on its liquidation and dissolution) or by a person that does not deal at arm's length with the taxpayer, or are deemed to have been disposed of by the taxpayer by reason of subsection 40(3). Under such an extended version of subsection 93(1.1), it would seem to us that it would not be possible for a taxpayer to "convert" undistributed "taxable surplus" into capital gains, and the taxpayer would be permitted to recover its investment (i.e., its ACB) before being required to recognize any income.

Limited Role for PUC in FA Context

In this regard, we submit, as we observed more generally above, that our approach is consistent with the functions performed in the Act of PUC as such, and that those functions and the tax policy underlying the significance of PUC in the domestic context are fundamentally distinguishable with respect to investments in FAs.

- It is our understanding that, in the domestic context, and in the inbound cross-border context (i.e., in the context of a distribution by a corporation resident in Canada), the concept of PUC has been employed in the Act as a means of *indirectly measuring* relevant undistributed corporate surplus. In effect, in this model, undistributed corporate surplus is equated with the difference, if any, between a corporation's PUC and the fair market value of its assets (net of its liabilities). This amount may or may not be reflected in the corporation's retained earnings, in the sense that retained earnings would normally not include any unrealized "appraisal surplus". However, the distribution by the corporation of any amount exceeding its PUC would nevertheless normally be characterized as a dividend pursuant to subsection 84(2), assuming that this provision were applicable in the circumstances, resulting in income recognition rather than cost-recovery treatment. As a corollary, the distribution (by way of a formal return of capital) by the corporation of an amount not exceeding its PUC would normally result in cost-recovery treatment. Similar parameters apply under subsection 84(3). Moreover, this concept is employed as an important element of the various "surplus stripping" rules applicable in relation to a corporation resident in Canada, such as sections 84.1 and 212.1, as a benchmark within which these rules are not engaged. That is, no deemed dividend arises to the extent that the "boot" (i.e., non-share consideration) received by the transferor does not exceed the PUC of the transferred shares. Thus, the principal function of this concept would appear to be to serve, essentially, as an *income measurement tool* – to measure the amounts that are accorded income recognition treatment (i.e., deemed

dividends), rather than cost-recovery treatment, in the context of a distribution by a *corporation resident in Canada*.

- In the context of a distribution by a FA, the concept of PUC has a much more limited function as a practical matter, because of two reasons.

  — First, in the FA context, the Act relies on a very detailed set of rules – the "surplus" computation rules in Part LIX of the Regulations – as a means of *directly measuring* relevant undistributed corporate surplus – which, in this context, does not include appraisal surplus in our view. That is, in this context, in very conceptual terms, we would submit that relevant undistributed corporate surplus includes only *realized* earnings – indeed, only those earnings realized through transactions other than "internal dispositions". Thus, it is not necessary to rely on PUC, or FPUC, in this regard.

  — Second, in our view, relying on PUC, or FPUC, in this regard would be inappropriate, in that it would be inconsistent with the notion that relevant undistributed corporate surplus in this context includes only *realized* earnings (i.e., only FA "surplus"). In other words, in this context, the rules would appear to be (and, in our view, should be) designed as much as possible so as to result in income recognition treatment only in amounts that are reflected in such "surplus", subject to the principle that the taxpayer (or a FA, as the case may be) should be permitted to recover its investment before recognizing any income, to which we will return below. As an illustration of the more general point, we note that both current and proposed Regulation 5902(6), which determines the amount of the deemed dividend arising in the FA context pursuant to subsection 93(1.1), provides for income recognition treatment only in the amount equal to the *lesser of*:

    - the *capital gain*, if any, otherwise determined in respect of the disposition of the relevant share,

    and

    - the amount that could reasonably be expected to have been received in respect of the share if the particular affiliate had at the relevant time paid dividends the aggregate of which on all shares of its capital stock was equal to the amount determined under Regulation 5902(1)(a) to be its *"net surplus"* in respect of the corporation (or, under the Draft Legislation, the amount of *"attributed net surplus"* (as determined under proposed Regulation 5902(1)(f)) in respect of the relevant share), determined on a consolidated basis.

    In other words, even the "surplus stripping" rules applicable in the FA context do not rely on PUC as a means of determining the amounts that should be accorded income recognition treatment. Rather, in the FA context, this determination is made as a function of "surplus" and "basis" (i.e., ACB), being a central determinant of capital gain). Indeed, PUC has nothing at all to do with the application of the surplus

stripping rule in subsection 93(1.1). Similarly, the relevant income measurement and surplus stripping rules in the Act that do rely on PUC (i.e., those in sections 84, 84.1 and 212.1) are deliberately disapplied in the FA context. For example, where FA1 disposes of FA2 for $100 at a time when FA1's ACB in the FA2 shares is nil and FA2 has $50 of "surplus" and no PUC, only $50 of deemed dividends would arise – not $100 as would be the case if PUC were the relevant benchmark. Likewise, where FA1 disposes of FA2 for $100 at a time when the underlying attributes are the same as just mentioned except that FA2 has $100 of PUC, $50 of deemed dividends would still arise – not *nil* deemed dividends as would be the case if PUC were the relevant benchmark. Thus, PUC (and, in our view, FPUC) simply is not (and, in our view, should not be) relevant in this regard. Rather, since the relevant (and direct) measure of undistributed corporate surplus in this context is FA "surplus", the relevant measure of the taxpayer's investment in the FA becomes ACB – once again, not PUC or FPUC. In this manner, the taxpayer is accorded (or, rather, subjected to) income recognition treatment (i.e., deemed dividends) only if and to the extent that the relevant affiliate has "attributed net surplus" in an amount that exceeds the taxpayer's investment (i.e., its ACB) in respect of the relevant shares. It is submitted that it would be inconsistent with this well developed infrastructure to now introduce a measure that would operate to produce deemed dividends in this context as a function of an affiliate's FPUC. Indeed, such a measure would seem to us to directly conflict with, and to produce results that would be inconsistent with those arising under, the regime reflected in current and proposed Regulation 5902(6).

- Thus, while PUC still plays a role under current rules in the context of FA distributions, that role is largely redundant, in that a FA distribution made in the form of a "return of PUC" is accorded essentially the same treatment as a FA distribution in the form of a dividend out of "pre-acquisition surplus", with two important exceptions.

  — A FA distribution made in the form of a "return of PUC" is accorded cost-recovery treatment in accordance with common law principles (to the effect that the distribution does not result in the recognition of income by the shareholder) and pursuant to subparagraph 53(2)(b)(ii). A FA distribution in the form of a dividend out of "pre-acquisition surplus" is also accorded cost-recovery treatment – in accordance with paragraph 113(1)(d), subsection 92(2) and subparagraph 53(2)(b)(i).

  — However, whereas a "return of PUC" can be used to "bypass" undistributed "taxable surplus" (subject to certain "exceptions"), a dividend out of "pre-acquisition surplus" arises only after "taxable surplus" has been depleted. We refer to "exceptions" to indicate that a "return of PUC" cannot be used to "bypass" undistributed "taxable surplus" if it results in a deemed disposition of the relevant shares under subsection 40(3), because the "return of PUC" exceeds the relevant ACB, and subsection 93(1.1) is applicable. In such a case, a deemed dividend would arise, thereby capturing the "taxable surplus". Nevertheless, a "return of PUC" can be used to "bypass" undistributed "taxable surplus" in all cases where there is sufficient ACB, which is appropriate in our view. Moreover, a "return of PUC" can be used to "convert" undistributed "taxable surplus" into a capital gain where the distribution is governed by subsection 88(3), or where the relevant shares are not EP, even where the

distribution exceeds ACB, since subsection 93(1.1) does not currently apply in either case. We will return to this issue below.

— Another important difference is that, in the context of a "return of PUC", no relief whatsoever is provided for under the Act in respect of any applicable foreign withholding taxes. In contrast, in the context of a dividend out of "pre-acquisition surplus", the ACB reduction provided for under subsection 92(2) is itself reduced by any applicable foreign withholding taxes, thereby granting relief under the Act in the form of latent loss (or less latent gain) on the relevant shares, given that such dividends do not constitute "exempt dividends" as defined in subsection 93(3) for the purposes of the stop-loss rule in subsection 93(2). Thus, assuming that there is no material undistributed "taxable surplus", the taxpayer would have an incentive under the Act to cause the distribution to be made in the form of a dividend out of "pre-acquisition surplus", if that would result in relief for any foreign withholding taxes that would be applicable in either case. Of course, if a "return of PUC" would in the first place avoid the application of foreign withholding taxes, that would remain the preferred form of distribution from a Canadian perspective, since the avoidance of foreign withholding tax would always be preferable to the limited form of relief in that regard provided for under subsection 92(2).

- It would seem to us that a regime that relies on FPUC would almost invariably violate at least one of the two principles intrinsic to the FA system even as it would be modified by proposed changes to the FA rules, and would give rise to inequitable results in many cases. For example, where a taxpayer acquires a FA from a third party and the FA has FPUC that exceeds its FMV at that time, a regime that relies on FPUC could put the taxpayer in a position to enjoy a tax benefit windfall at some point in the future, in allowing the taxpayer to "convert" undistributed "taxable surplus" into a capital gain by making an FPUC distribution that exceeds ACB. Similarly, and unless remedial action is taken, where a taxpayer acquires a FA from a third party and the FA has FPUC that is lower that its FMV at that time, a regime that relies on FPUC could put the taxpayer in a position to suffer a tax disadvantage at some point in the future, in that the taxpayer would not be permitted to recover its actual investment (i.e., its ACB) before being required to recognize income.

Recommendations

Against that background, and as a means of mechanically implementing these principles, our recommendations are as follows. A number of examples of the application of the regime described below are set forth in the Appendix.

1. Where shares of a FA held by a taxpayer resident in Canada are redeemed, acquired or cancelled by the FA (including on its liquidation and dissolution, or on a merger) or by a person that does not deal at arm's length with the taxpayer, the position would be mandatory (i.e., the extended subsection 93(1.1) would be engaged) and would provide for income recognition treatment (i.e., deemed dividends) to the extent of the lesser of the amount of any capital gain otherwise resulting from the disposition and the amount of the relevant "attributed net surplus", and would provide for cost-recovery treatment (i.e., proceeds of disposition or deductions from ACB) for the balance.

2. Where a dividend payment or other distribution of property (excluding, for greater certainty, any transaction described in the preceding paragraph) is made by a FA, the position would be elective, with income recognition treatment (i.e., an actual or deemed dividend) being the default position. That is, the distribution would either be or would in any event be treated as a dividend, except to the extent that the taxpayer designated that all or part of the amount of the distribution should be accorded cost-recovery treatment (i.e., deducted from ACB). If the amount of the distribution that is designated for cost-recovery treatment exceeds the taxpayer's ACB in the relevant shares, then a capital gain would arise under subsection 40(3), and dealt with as described below. Although we have struggled with this notion to some extent, we ultimately concluded that an elective mechanism would be most neutral, most efficient and most equitable in the circumstances. In particular, we note that, since there would be a difference between FPUC and corporate legal character if an FPUC regime were introduced as contemplated, some type of mechanical rule would have to be introduced to determine when a distribution that in law is made in the form of a dividend should be treated as a distribution of FPUC. In this regard, we understand you are considering the use of a designation mechanism. Inspired by this approach, we suggest a designation mechanism be used for all dividends or other distributions. This would be most efficient, as time and expense would not have to be spent by taxpayers or the tax administration trying to characterize the distribution as a matter of foreign corporate law. Also, this would be most neutral and most equitable, since it would eliminate the possibility of anomalies in Canadian tax treatment resulting from differences in the foreign corporate laws of various countries. Moreover, it would eliminate the possibility of anomalies in Canadian tax treatment resulting from differences in the foreign tax laws of various countries (ie, taxpayers often prefer to capitalize FAs without creating formal legal capital, as a means of minimizing foreign capital duties).

3. Where a taxpayer is deemed to have realized a capital gain under subsection 40(3) because of a cost-recovery designation (as opposed to because of the "attributed net surplus" of the relevant FA having been depleted), the extended subsection 93(1.1) would be engaged, such that the taxpayer would be precluded from 'converting" undistributed "taxable surplus" into a capital gain. In contrast, where a taxpayer is deemed to have realized a capital gain under subsection 40(3) but the "attributed net surplus" of the relevant FA has been depleted, a capital gain would quite properly arise.

4. The "amount" of the distribution (whether ultimately accorded income recognition treatment or cost-recovery treatment) would be determined largely as described in the Draft Legislation (i.e., in certain cases, as a function of whether or not EP is being distributed; in certain cases, as a function of the taxpayer's percentage equity interest in the relevant FA – such as under proposed paragraph 95(2)(e.1); in certain cases, as a function of the nature of the transaction – such as in the case of a "foreign merger" governed by the broader form of paragraph 95(2)(d.1) currently under consideration, etc.).

5. A similar approach would be taken in the context of inter-affiliate distributions and analogous transactions. Subsection 93(1.1) would be applicable as a matter of course in respect of share dispositions, and otherwise distributions would result in deemed dividends subject to the taxpayer's cost-recovery treatment designation.

6. Reorganizations of capital and share-for-share exchanges with issuer FAs (e.g., transactions to which section 51 or 86 is applicable) would be excluded from the scope of a "distribution" as such, but would engage the application of subsection 93(1.1) to the extent that a capital gain would otherwise arise and there is "attributed net surplus".

Finally, we would note in this regard that the introduction of such a broad deemed dividend/cost-recovery designation regime would seem to us to be perfectly consistent in fundamental respects with the notion of recharacterizing proceeds of disposition as deemed dividends under subsection 93(1.1) or otherwise. For example, both under existing rules and under the Draft Legislation, the treatment of a share redemption is not constrained by foreign corporate and commercial law, in the sense that the Act generally permits under subsection 93(1) and in certain cases requires under subsection 93(1.1) that what would otherwise be characterized as proceeds be recharacterized as dividends. A broad deemed dividend/cost-recovery designation regime would seem to us to be analogous – and would facilitate efficient administration of and compliance with the Act. In the latter regard, we would submit that any regime that can "piggy-back" off existing infrastructure in the Act and Regulations would be preferable to one that would require the development of new concepts and the tracking of information that is not otherwise useful. Thus, our recommended approach has been designed to operate on the basis of information that is already required to be maintained and serves various material purposes – namely, ACB and "surplus". In contrast, the adoption of a new regime that operates on the basis of FPUC would not only require the introduction of this new concept (which, in itself, is probably not that material) but also would require the gathering and maintenance of information dating back to the creation of the relevant FAs, which could impose material and, in certain cases, insurmountable administrative and compliance burdens on all concerned, particularly in circumstances where a taxpayer has acquired a FA that has undergone or participated in share capital or other corporate and commercial reorganizations, which can result in changes to legal capital accounts without corresponding contributions or distributions.

FPUC Currency

Assuming that the FPUC regime should be introduced, a related question that arises is which currency such FPUC should be maintained in. In this regard, it is our submission that such FPUC should be maintained in the currency that is relevant in computing the affected shareholder's income or capital gain from a disposition of the relevant FA shares. Our view in this regard is based on the proposition that such FPUC would be intended to serve as an indirect (if inaccurate) measure of the amounts that should be accorded income recognition treatment in the context of a distribution of relevant undistributed corporate surplus, and the principle that the taxpayer should be permitted to recover its investment before being required to recognize any income. Assuming this principle is relevant here, it would seem to us to be appropriate that a significant element of the taxpayer's income determination such as FPUC should accordingly be maintained in the same currency.

This approach would also appear to minimize inefficiencies and other arguably inappropriate results that can arise because of fluctuations in the value of the currency in which the FPUC is maintained relative to the value of the shareholder's relevant currency. For example, if FPUC were maintained in a currency other than the shareholder's relevant currency, then an increase in

value of that currency, relative to the value of the shareholder's relevant currency, would increase the amount that could be received by the shareholder as a "return of FPUC" – free of income recognition (i.e., free of deemed dividends), thereby permitting the taxpayer to "convert" a distribution of "taxable surplus" into a capital gain to this extent. Thus, if a Canadian-resident shareholder invested $100 in the capital of a FA, maintaining the resulting FPUC in Canadian dollars would ensure that the shareholder could recover no more and no less than that initial $100 on a cost-recovery basis. In contrast, maintaining that FPUC in another currency would virtually always result in "slippage". If the value of that other currency increased relative to the Canadian dollar, such that the value of the relevant foreign currency units increased, say, from $100 to $150, then the FA could distribute an "amount" equal to $150 to the shareholder as a "return of FPUC", thereby permitting the "conversion" of $50 of "taxable surplus" into a capital gain. Conversely, the shareholder's interests can be adversely affected by a currency movement in the opposite direction, in that the shareholder might not be able to receive its initial investment of $100 as a "return of FPUC" (depending on how distributions would be characterized for this purpose), since the value in Canadian dollars at that time of the FPUC would be less than $100.

Hedging Arrangement Currency

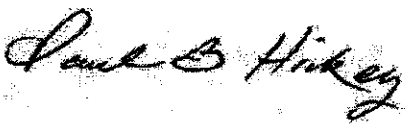
In our submission to you dated September 18, 2003, in relation to the December 20, 2002 version of the proposed amendments, we recommended that certain clarifications and other revisions be made with respect to the proposed amendments relating to foreign exchange hedging arrangements (e.g., proposed paragraph (c.1) of the definition of "excluded property" in subsection 95(1), proposed subparagraph 95(2)(a)(vi), and proposed paragraph 95(2)(i)). In particular, we recommended that the language of these provisions be clarified by providing that a hedging arrangement would qualify under these rules (assuming other relevant conditions were satisfied) if it was entered into by the relevant FA "to reduce its risk, with respect to an amount ..., of fluctuations in the value of the currency in which the amount was denominated *relative to any other currency*". Given that the version of these proposals in the Draft Legislation, in relevant part, is effectively the same as the prior version, we reiterate our recommendation in this regard.

Moreover, we note that it would strike us as being anomalous that the combined effect of the FA financing and hedging rules would be to accommodate a situation in which, for example, one FA makes a loan to another FA in a particular currency other than the lender's calculating currency (e.g., the currency in which the lender has issued funding obligations (the "funding currency")) but would not accommodate the analogous and functionally equivalent situation in which the loan is made in a currency other than the lender's calculating currency and other than the funding currency (e.g., the borrower's currency, where that differs), and the lender then hedges its exposure with reference to the risk of fluctuations in the value of the borrower's currency relative to the value of the funding currency by "swapping" its "long" exposure to the borrower's currency for "long" exposure to the funding currency, or *vice versa*. In the first case, the lender would have created a "natural hedge" by lending in the funding currency. In the second case, since the lender would have made the loan in the borrower's currency, there would not be any "natural hedge", but the lender would have created an equally perfect hedge by "swapping" its "long" exposure to the borrower's currency for "long" exposure to the funding currency. In other words, if there is no restriction on the currency in which a qualifying 95(2)(a)(ii) asset can

be initially denominated or subsequently redenominated, then it would seem to us to be anomalous that there should be any restriction on the currency in which a qualifying hedging arrangement can be denominated.

We would be pleased to elaborate on our thoughts in this regard, including with respect to transitional issues, should you consider it to be advisable to consult with us further in this regard.

Yours truly,



Paul B. Hickey, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

William R. Holmes
Chair, Taxation Section
Canadian Bar Association

Cc: Wally Conway – Department of Finance

Appendix

Example 1 – Legitimate Bypassing of Undistributed Taxable Surplus

Facts:

- Canco acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing "taxable surplus") of $50
- CFA "capitalizes" its undistributed retained earnings
- CFA distributes an "amount" that does not exceed Canco's ACB – say, $100

Consequences:

- No deemed dividend or other consequence when CFA "capitalizes" its undistributed retained earnings
- Canco would be deemed to receive a dividend of $100 (thus, $50 out of "taxable surplus" and $50 out of "pre-acquisition surplus"), unless Canco elected cost-recovery treatment for the entire "amount", in which case no deemed dividend or capital gain would arise, but Canco's ACB would be completely depleted – Canco would have fully recovered its investment of $100, but no more than that.

Example 2 – Capitalization of Undistributed Taxable Surplus

Facts:

- Canco acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing "taxable surplus") of $50
- CFA "capitalizes" its undistributed retained earnings
- CFA distributes an "amount" that exceeds Canco's ACB – say, $125

Consequences:

- No deemed dividend or other consequence when CFA "capitalizes" its undistributed retained earnings
- Canco would be deemed to receive a dividend of $125 (thus, $50 out of "taxable surplus" and $75 out of "pre-acquisition surplus"), unless Canco elected cost-recovery treatment for at least the portion of the "amount" that is within its ACB (which is assumed), in which case a deemed dividend of $25 (out of "taxable surplus") would arise. No capital gain would arise, but Canco's ACB would be completely depleted. Thus, Canco would have fully recovered its investment $100, and recognized a return on investment of $25, accounted for as a dividend out of "taxable surplus".

Example 3 – Stripping of Undistributed Taxable Surplus

Facts:

- Canco1 acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing "taxable surplus") of $50
- Canco1 transfers CFA to Canco2 (a wholly-owned subsidiary) in exchange for shares of Canco2 and cash in an amount that exceeds Canco1's ACB – say, $125 (such that a section 85 election is duly made for $125, where FMV is $150)
- CFA distributes an "amount" that exceeds Canco2's ACB – say, $150

Consequences:

- No deemed dividend or other consequence when CFA "capitalizes" its undistributed retained earnings
- On the transfer by Canco1 to Canco2, Canco1 would be deemed to receive a dividend of $25 (out of "taxable surplus"), and this amount would be excluded from its proceeds of disposition of the CFA shares, such that no gain would arise. Canco2's ACB would be $125. Moreover, CFA's "taxable surplus" would be reduced by $25 to $25.
- On the subsequent distribution to Canco2, Canco2 would be deemed to receive a dividend of $150 (thus, $25 out of "taxable surplus" and $125 out of "pre-acquisition surplus"), unless Canco2 elected cost-recovery treatment for the entire "amount" of the distribution, in which case it would still be left with a deemed dividend of $25 out of "taxable surplus". That is, if Canco2 elected cost-recovery treatment for the entire "amount" of the distribution, what would happen is that it would be deemed to have a gain of $25 under subsection 40(3), such that subsection 93(1.1) would apply to result in a deemed dividend of $25 out of "taxable surplus".

Example 4 – Stripping of Undistributed Taxable Surplus

Facts:

- Same as Example 3, except CFA already had PUC of $200 when it was acquired by Canco1, so no "capitalization" is made of its undistributed retained earnings

Consequences:

- Same as Example 3. In contrast, we note that an FPUC regime along the lines of that under consideration would seem to permit the undistributed "taxable surplus" in such a case to be "converted" to capital gains – $25 in the hands of each of Canco 1 and Canco 2 – unless further supporting deemed dividend provisions are introduced, to address "capitalizations", "stripping" transactions, and similar arrangements.

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

The Canadian Bar Association	The Canadian Institute of
500-865 Carling Avenue	Chartered Accountants
Ottawa, Ontario	277 Wellington Street West
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November 3, 2004

Mr. Brian Ernewein,
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada
17th Flr., East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Mr. Ernewein:

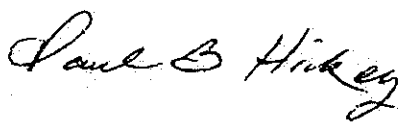
Re: Draft Submission in respect of the February 27, 2004, Draft Legislation--Proposed Amendments to the Foreign Affiliate Rules

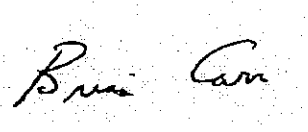
Further to our previous discussions and communications with you and your officials, including our letter of October 8, 2004, we are enclosing our draft submission regarding the above.

Based on what we understand to be the government's current legislative timetable and priorities it has become apparent to us that we are not going to be able to complete this submission in final form in a timely manner. Therefore, in the interest of providing our comments assembled to date, we provide you with our draft submission. The draft submission incorporates many issues previously discussed with you and your officials. As you will appreciate, the topic area and the specific provisions are extremely complicated and new issues are arising on a regular basis. We will endeavor to communicate additional issues to you.

We would be pleased to meet with you once again to discuss these complicated issues and provide our input. As always, we appreciate the opportunity to discuss matters with you.

Yours very truly,





Paul B. Hickey

Chair, Taxation Committee

Canadian Institute of Chartered Accountants

Brian R. Carr

Chair, Taxation Section

Canadian Bar Association

Cc Mr. Wallace Conway, Chief Tax Legislation Division, Tax Policy Branch

SEJ:k
Enclosure

Submission of the CICA–CBA Joint Committee on Taxation in respect of the February 27, 2004, Draft Legislation Concerning Foreign Affiliates

Introduction

The February 27, 2004, Draft Legislation contains numerous proposals (the "Legislative Proposals") concerning the foreign affiliate rules in the *Income Tax Act* (the "Act") and the *Income Tax Regulations* (the "Regulations"). This Submission is intended to put forth the comments of the CICA–CBA Joint Committee on Taxation in respect of the more salient features of the Legislative Proposals.

Our Submission is divided into two main parts. The first part sets out our comments with respect to the conceptual and policy underpinnings of, as well as the practical considerations associated with, certain of the proposed amendments only – namely, those relating to Internal Dispositions, Reorganizations and Distributions, Surplus Adjustments and Subsection 93(1) Deemed Dividends, as well as certain comments on the regulations corresponding to paragraph 95(2)(a) of the Act. The second part consists of an Appendix, which catalogues a number of our more technical comments and recommendations.

Internal Dispositions, Reorganizations and Distributions

It is our understanding that many of the numerous changes proposed in relation to so-called "internal dispositions", reorganizations and distributions are intended to address concerns of the Department with respect to the "premature" realization and/or "duplication" of exempt surplus (and certain other tax attributes, such as ACB, or "foreign accrual property losses" ("FAPL")). While that objective may be understandable, we respectfully submit that the Department's approach as reflected by the Legislative Proposals gives rise to a number of quite serious concerns with respect to the implications of these measures.

We understand, moreover, that the Legislative Proposals relating to internal dispositions, reorganizations and distributions are being revisited by the Department, and it is in that context that our comments have been formulated. That is, we begin our review of this part of the Legislative Proposals with a discussion of the principles that we believe should govern this aspect of the foreign affiliate regime, and then continue in the Appendix hereto with a summary of numerous technical concerns that arise in relation to the Legislative Proposals as currently drafted, with a view to assisting the Department in its reconsideration of these measures both from a conceptual perspective and from a more technical standpoint.

Internal Dispositions

As noted above, we believe that it is understandable that the Department would be concerned about the "premature" realization and/or "duplication" of exempt surplus and other

relevant tax attributes. However, we submit that any measures introduced to address these concerns should be consistent with the following principles:

- Arm's Length Principle. These measures should not affect the treatment of transactions between parties dealing at arm's length.
  - We believe that it is inappropriate for transactions between parties dealing at arm's length to be treated as though they are somehow "artificial" and not worthy of recognition for these purposes. Normally, transactions between parties dealing at arm's length by definition carry all the badges of independent market dealings and, therefore, represent the most reliable indicators of realized economic value. Thus, to the extent that the surplus rules are intended to reflect the realized economic value within a particular foreign affiliate, then these transactions should in principle be recognized, subject to appropriate relief in certain cases.
  - The proposed income, gain and loss suspension rules for "internal dispositions" are similar in many respects to certain of the "stop-loss" rules applicable more generally for the purposes of the Act, such as subsection 40(3.4). In general terms, these rules may apply to suspend losses otherwise arising from transactions involving "affiliated persons". These rules are consistent with the arm's length principle, since "affiliated persons" in the corporate context normally share a control bond (or similar relationship).[1] The same is true for a wide range of other anti-avoidance rules scattered throughout the Act, from paragraph 13(7)(e) to section 247, and otherwise.
  - Accordingly, it is our view that any measures introduced to address these concerns in the foreign affiliate context should be applicable only in respect of transactions between persons that are not dealing at arm's length. Thus, the proposed definitions of "specified vendor" and "specified purchaser"[2] should be revised such that they include only persons that are not dealing at arm's length with the relevant taxpayer at the relevant time.
- Consistency/Neutrality. These measures should apply consistently and even-handedly, in a manner which maximizes fiscal neutrality in this context – that is, without regard to whether there is an accrued gain or loss on the particular asset.
  - The proposed income, gain and loss suspension rules for "internal dispositions" as currently drafted reflect what we believe to be an inappropriate bias. That is, income and gains from the disposition of excluded property can be suspended, but

[1] See the rules in section 251.1.

[2] See the definitions in proposed subsection 95(3.2) and following.

losses cannot. Similarly, losses from the disposition of non-excluded property can be suspended, but income and gains cannot.

- It is submitted that the "validity" or "artificiality" of a particular transaction should be determined with reference to the circumstantial context in which it occurs (i.e., whether or not it occurs between parties dealing at arm's length), and not as a function of whether it produces a result which is favourable rather than unfavourable to the taxpayer or to the Crown. If a particular transaction should not be recognized because of the circumstantial context in which it occurs, then it seems unfair for the rules to depart from that approach for the singular purpose and only to the extent of imposing unfavourable consequences on the taxpayer.

- Accordingly, it is our view that the scope of proposed paragraphs 95(2)(c.2) and (f.4) should not be restricted to dispositions of excluded property, and that of proposed paragraph 95(2)(h.1) should be expanded to apply to excluded property, or both should be abandoned.

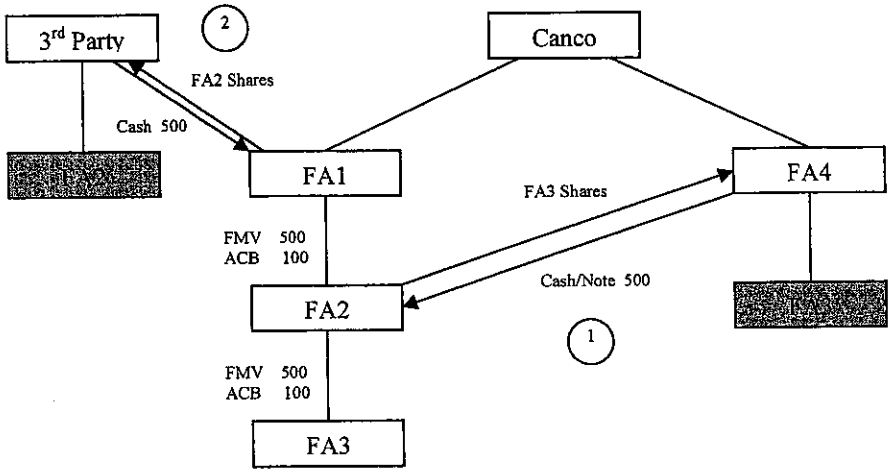
- Efficiency and International Competitiveness. These measures should not introduce inordinate administration and compliance burdens into the system, or improvidently interfere with the ability of Canadian-based multinational enterprises to arrange and restructure the affairs of their corporate groups in such a manner as to maximize their international competitiveness.

  - There are three aspects of the Legislative Proposals which we believe are inconsistent with these very important principles. First, there is the aspect of these measures which introduces the notion of suspended income, gains and losses (as opposed to simply introducing another category of surplus or deficit and perhaps grafting it onto the existing infrastructure in the Regulations). Second, there is the aspect of these measures which can result in the realization of FAPI in respect of a disposition of excluded property, rather than simply preventing or discouraging the *Canadian use* of any exempt surplus (or FAPL or other relevant tax attribute) otherwise arising. Third, there is the aspect of these measures that regulates the "unsuspension" or "release" of the suspended items, which does not sufficiently accommodate structured divestitures and certain very important timing considerations.

  - While the more general concern from the Department's perspective may be described in part as the "premature" realization of exempt surplus and other tax attributes, we understand that one of the more important specific manifestations of this concern arises in relation to the repatriation of economic value into Canada on the basis of such "premature" attributes. That is, we understand that the Department may in certain cases be concerned about circumstances in which, for example, exempt surplus arises from an "internal disposition" of shares of a

foreign affiliate that constitute excluded property, and then this exempt surplus is used, given the ordering rule in Regulation 5901, to repatriate to Canada economic value which reflects realized taxable surplus unsupported by sufficient underlying foreign tax.

- It is submitted that this concern, while understandable, falls short of justifying the introduction of as intrusive a regime as that reflected in the Legislative Proposals. Moreover, it is submitted that the proposed regime could well be completely ineffective in addressing this concern in many cases, and would produce harsh and otherwise inappropriate results in other cases. Consider the following example:



Essentially, FA2 sells FA3 to FA4 in consideration for cash or a promissory note. Proposed paragraph 95(2)(c.2) would suspend the gain that would otherwise result. FA1 then sells FA2 to a 3rd Party. The gain realized here would reflect the same economic gain as that inherent in the FA3 shares, but proposed paragraph 95(2)(c.2) would not suspend this gain. Moreover, since the gain that would otherwise result from the sale of FA3 by FA2 is suspended, the gain from the sale of FA2 by FA1 would not be reduced by subsection 93(1.1). Thus, the gain from the sale of FA2 by FA1 may produce FAPI or not, depending on whether the FA2 shares are excluded property at the time of their sale, but will in any event produce unsuspended surplus.

- It is submitted that this concern could be addressed by the introduction of a new category of surplus, which could be regarded as "suspended surplus", and which could be grafted onto the existing infrastructure in the Regulations. This approach would permit "suspended surplus" to be used to transfer economic value

between foreign affiliates, but not to repatriate economic value into Canada ahead of taxable surplus.

- Essentially, the principal features of this alternative approach could be summarized as follows:

  - All income, gain or loss from an "internal disposition" of excluded property would result in "suspended surplus" or "suspended deficit", except to the extent that it would otherwise be accounted for in computing "taxable surplus" or "taxable deficit", and only until the relevant "release event" occurs. In other words, "suspended surplus" or "suspended deficit" would include only what would otherwise be included in exempt surplus or deficit. What would otherwise be included in taxable surplus or deficit would not be suspended.

  - Dividends considered to be paid out of such surplus would be excluded from the FAPI of a foreign affiliate, and would be deductible in the hands of a corporate taxpayer resident in Canada only to the extent of any grossed-up withholding or underlying foreign tax applicable thereto. In brief, they would be treated in the same manner as dividends paid out of taxable surplus.

  - Once a "release event" occurs, then the "suspended surplus" or "suspended deficit" would be accounted for in computing exempt surplus or deficit. In the meantime, such "suspended surplus" or "suspended deficit" could be moved from one foreign affiliate to another, and could be adjusted or consolidated in the event of a change to the relevant taxpayer's surplus entitlement percentage ("SEP") or a relevant foreign affiliate reorganization.[3]

  - Since such "suspended surplus" would be treated in the same manner as taxable surplus, it could not be used to repatriate economic value to Canada on a tax-free basis except to the extent that an appropriate amount of foreign withholding or underlying tax has already been paid.[4]

  - Release events would include circumstances in which the relevant vendor affiliate ceased to deal at arm's length with the relevant taxpayer, as well

[3] For example, if FA1 had a "suspended deficit" and FA2 had "suspended surplus", and FA1 received a dividend from FA2 out of the latter's "suspended surplus", then that "suspended surplus" dividend would offset FA1's "suspended deficit", and so on.

[4] It would be our suggestion in this regard that a separate UFT pool be maintained for each of "taxable surplus" and "suspended surplus".

as those in which the relevant property ceased to be held by a person not dealing at arm's length with the relevant taxpayer (either because the relevant property or the relevant holder was disposed of to an arm's length party, or ceased to exist in certain cases). Timing issues would also be addressed in such a manner as to ensure that these measures would not apply in the context of structured divestitures (i.e., where the relevant property has left the non-arm's length group within 30 days), and to ensure that any "suspended surplus" would become available immediately before an arm's length disposition of the relevant affiliate, particularly where the specified property exits the non-arm's length group at the time of the arm's length disposition of the relevant affiliate (i.e., where the specified property is "downstream" of the relevant affiliate).

- The advantages of this approach would seem to include the following:

  - Because this new category of "suspended surplus" could be grafted onto the existing infrastructure in the Regulations, there would be no need to develop alternative infrastructure to address surplus tracking and continuity issues arising in the context of changes to the relevant taxpayer's SEP or various types of corporate reorganizations.

  - By grafting this new category of "suspended surplus" onto the existing infrastructure in the Regulations, the Department would ensure that the surplus consequences of changes to the relevant taxpayer's SEP or various types of corporate reorganizations would be the same (i.e., appropriately analogous) in the context of realized surplus as in the context of "suspended surplus", so it would be less likely that anomalies could arise that could either be exploited by taxpayers or work to their disadvantage in particular circumstances.[5]

  - This approach would reduce administrative and compliance costs because it would be implemented using existing legislative infrastructure in respect of which both the CRA and taxpayers already have established processes. This would avoid the need to develop new administrative and compliance processes, as well as the associated costs.

[5] As a further example, because this approach would permit "suspended surplus" to be used to transfer economic value between foreign affiliates, it would not require the development of a whole new set of rules to govern the application and interaction of subsection 40(3). We would note, however, that dispositions arising because of the application of subsection 40(3) should be treated as "internal dispositions" only if the relevant taxpayer and the issuing affiliate do not deal at arm's length.

- Since this "suspended surplus" would be treated in the same manner as taxable surplus, the Canadian tax base would be fully protected, and there would be no need to require the recognition of FAPI as a condition of surplus recognition.[6]

- Since this approach would permit "suspended surplus" to be used to transfer economic value between foreign affiliates, it would not in any way interfere with the ability of Canadian-based multinational enterprises to arrange and restructure their foreign corporate groups in such a way as to maximize their international competitiveness. We would emphasize that it is very important not to lose sight of the fact that "internal dispositions" are essential tools in the context of structuring and restructuring Canadian-based multinational corporate groups with a view to minimizing foreign costs, including foreign tax and regulatory burdens, and thereby maximizing Canadian competitiveness and wealth.

We would be pleased to discuss this alternative approach with you in greater detail should you be interested in so doing. In addition, with reference to the Legislative Proposals as currently drafted, we offer the more technical recommendations set out in the Appendix hereto.

Reorganizations

A wide range of revisions is proposed in relation to the foreign affiliate rules in the Act and Regulations governing the consequences of certain reorganizations. We refer, in particular, to proposed new paragraphs 95(2)(d) to (e.1), and related provisions.

These proposed revisions appear to be animated significantly by the same concerns as those reflected in the proposed new income, gain and loss suspension rules. That is, in large measure, these proposed revisions would restrict the recognition of surplus otherwise arising in the context of a foreign merger or liquidation. However, in our view, these proposals would appear to go beyond that consequence in important respects, resulting in some cases in the inappropriate recognition of FAPI.

Foreign Mergers

With respect to the aspects of these revisions which are driven by the same concerns as those reflected in the proposed new suspension rules, we would submit the same

[6] We would nevertheless acknowledge that FAPI recognition could still serve as a condition of *exempt surplus* recognition. That is, FAPI recognition could be a condition to the relevant taxpayer electing to opt out of the "suspended surplus" rules in respect of a particular "internal disposition", in which case any income or half of any gain would be FAPI. Presumably, taxpayers may choose to do so if the disposition results in sufficient underlying foreign tax.

recommendation – namely, that any new rules developed in this context should be consistent with the general principles set out above in relation to the suspension rules – subject to the caveat that the reorganization context may give rise to certain particular considerations and concerns.

- Arm's Length Principle, and Consistency. It is submitted that there is no need to distinguish in this context between circumstances in which the relevant taxpayer has or does not have a SEP of at least 90% in the relevant foreign affiliate(s). Moreover, if any such distinction is to be made, on the basis of the taxpayer's percentage interest in the relevant foreign affiliate(s), then it is submitted that this distinction should be based on whether or not the taxpayer deals at arm's length with the relevant foreign affiliate(s), not based on the taxpayer's SEP in the relevant affiliate(s), and certainly not based on a 90% ownership threshold. We will return to the latter point below.

    - The SEP standard is problematic in this context, since there can be circumstances in which a taxpayer can have *nil* SEP in respect of an indirect wholly-owned foreign affiliate,[7] and there can be circumstances in which a taxpayer can have a SEP of 100% in respect of a particular affiliate even though the taxpayer holds less than 100% of the affiliate's equity.[8] Thus, it is submitted that the SEP standard is simply not a reliable indicator of the relationship between a relevant taxpayer and a particular foreign affiliate.

    - Foreign mergers normally result in a pooling of interests in the underlying corporate assets, without any exchange or extraction of a substantial amount of cash or near-cash consideration, and therefore in our view should not be treated as taxable transactions, even for arm's length shareholders, assuming that the terms of the definition of "foreign merger" in subsection 87(8.1) are satisfied.

        - There is no minimum percentage interest requirement that applies under section 87, whether in the domestic or in the international context. That is, at the shareholder level, subsection 87(4) applies (either on its own in the domestic context or in conjunction with subsections 87(8) and (8.1) in the international context) regardless of the taxpayer's percentage interest in

[7] For example, where Taxpayer holds FA1 (which has a net deficit of, say, $100) and FA1 holds FA2 (which has net surplus of, say, $100), and either FA1 or FA2 has more than one class of shares outstanding. In such a case, the formula applicable under Regulation 5905(13) and related provisions would yield a SEP of *nil* in respect of the taxpayer even in this wholly-owned context.

[8] For example, where Taxpayer holds 100% of a class of an affiliate's shares, and another person holds 100% of another class of the affiliate's shares, and the two classes rank equally with respect to dividends and other distributions, the formula applicable under Regulation 5905(13) and related provisions would yield a SEP of 100% in respect of the Taxpayer at any time at which the affiliate had *nil* net surplus.

the relevant corporation(s). The same is true under proposed paragraph 95(2)(d) and subsections 87(4), (8) and (8.1).[9]

- The anomaly arises at the asset level. Under domestic corporate law, an amalgamation does not normally result in the disposition of property (other than cross-shareholdings and similar items). Thus, although section 87 does not deem the relevant predecessor corporations to have disposed of their properties at tax cost, the underlying assumption of the Act in the domestic context is that there is no disposition as a matter of the governing corporate law, so there is no need for a statutory rollover.[10] In the foreign context, however, that assumption cannot be made, in that the corporate law applicable in various foreign jurisdictions does indeed result in a disposition of predecessor property, particularly where the relevant predecessor does not "survive" the merger.

- Thus, it would be appropriate in our view for proposed paragraph 95(2)(d) to provide for a rollover in respect of any predecessor property which is disposed of in the course of the merger (provided that, as a result of the merger, such property either becomes property of the corporation resulting from the merger or is extinguished by operation of law under the doctrines of merger, confusion or any similar doctrine or principle) and this, without regard to whether or not the property in question constitutes excluded property, and without regard to the taxpayer's percentage interest in the relevant predecessor affiliate.

- In stark contrast, however, proposed paragraph 95(2)(d) not only lacks a rollover in respect of non-excluded property, but in addition deems all non-excluded property to have been disposed of for fair market value consideration even if there is no disposition of such property as a matter of the governing corporate law, all the while deeming excluded property to have been disposed of at tax cost. It is respectfully submitted that this provision, as currently drafted, reflects a considerable bias adverse to taxpayers. This rule never helps the taxpayer – on the contrary, it suppresses exempt surplus from the disposition of excluded property, and it forces the recognition of unrealized FAPI.

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[9] Oddly, voluntary partial gain recognition is permitted only in respect of shares that are excluded property, even though a FAPI addition results from any such gain recognition as if the shares were not excluded property. It is difficult to understand the reason(s) for this distinction.

[10] Reference can also be made to proposed new paragraph (n) of the definition of "disposition" in subsection 248(1), which would deem there not to have been any disposition of certain property (e.g., certain cross-shareholdings) on a qualifying domestic amalgamation or foreign merger.

- Proposed paragraph 95(2)(d) must be read together with proposed paragraph 95(2)(d.1). Although the primary dividing line for the application of proposed paragraphs 95(2)(d) and (d.1) would continue to be the 90% SEP threshold,[11] that would not be the only one. That is, proposed paragraph 95(2)(d.1) would not apply to a foreign merger:

  > ... where, under the income tax law of the country in which the predecessor foreign corporations were resident immediately before the merger, any income, gain or loss was recognized in respect of any property of a predecessor foreign corporation that became property of the new foreign corporation in the course of the merger ...

  Thus, where the merger is a non-recognition transaction under the relevant foreign tax law, or where there is no relevant foreign tax law (i.e., where the predecessors are resident in a country that does not have an applicable tax law, or are resident in different countries), proposed paragraph 95(2)(d.1) can apply. Otherwise, it would appear that the application of proposed paragraph 95(2)(d) would not be displaced by proposed paragraph 95(2)(d.1), even if the 90% SEP requirement were met. This is a particularly troubling observation – FAPI could be realized on the merger of two wholly-owned foreign affiliates simply because the transaction is a recognition transaction, with respect to some property, under the applicable foreign tax law.[12]

- If an asset-level rollover is provided for without regard to the relevant taxpayer's percentage interest in the particular affiliate(s), it would seem to be possible for the taxpayer to avoid future FAPI in respect of an accrued gain on non-excluded property of its CFA, by causing the CFA to be merged with another entity in a dilutive horizontal merger, thereby experiencing a dilution of the taxpayer's percentage interest in the CFA and a consequential reduction of future FAPI attribution. However, this is a "sword" that "cuts both ways", in that a merger would normally likewise result in a corresponding reduction of future exempt surplus in respect of any accrued income or gain on excluded property of the CFA. In other words, since there is no mechanism to adjust the amount of any future FAPI or exempt surplus as a function of any change to a relevant

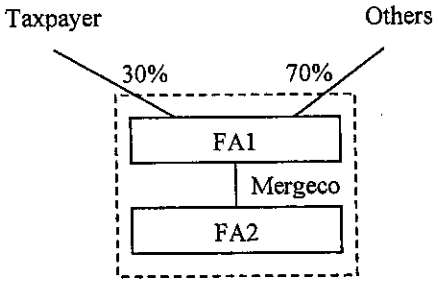
[11] A similar dividing line is drawn between proposed paragraphs 95(2)(e) and (e.1).

[12] Although this aspect of proposed paragraph 95(2)(d.1) is essentially the same as under current law, the effect is different because, under current law, paragraph 95(2)(d) does not result in a deemed disposition of non-excluded property.

taxpayer's SEP as between the time when the income or gain accrued and the time it is realized, a merger always produces "slippage" (whether positive or negative from the taxpayer's perspective). Although we would not recommend that a mechanism be introduced to address this type of "slippage", it is our submission that the existence of the possibility of such slippage does not justify restricting access to the asset-level rollover to non-arm's length (or greater percentage interest) circumstances.

- This type of "slippage" also arises where a taxpayer's percentage interest in respect of a particular affiliate is diluted because of a share issuance by the particular affiliate. It would seem pointless to address "slippage" in the context of a merger but not otherwise.

- There would be many circumstances in which a merger does not result in any change to the relevant taxpayer's percentage interest in the particular affiliate – and, therefore, does not result in any such "slippage". A compelling case can certainly be made for an asset-level rollover in this context, regardless of the relevant taxpayer's percentage interest in the particular affiliate. Consider the following example:



In this example, FA2 was a wholly-owned subsidiary of FA1, until the merger. Before the merger, the Taxpayer's percentage interest in FA2 was 30%, which is the same as the Taxpayer's percentage interest in FA2 after the merger. Clearly, there can be no "slippage" of the kind described above in such circumstances, and therefore there would seem to be no reason to deny a rollover at the asset level, regardless of the taxpayer's percentage interest in particular affiliate. This example illustrates a true case of change in form alone, which in our view should never result in any Canadian tax cost.

➢ At a minimum, even if an asset-level rollover is not provided for under proposed paragraph 95(2)(d), it is our submission that this provision should be modified such that there would be no deemed disposition of property which is not disposed of as a result of the merger as a matter of the governing corporate law.

- For an entity that "survives" a foreign merger, the merger is equivalent to an asset acquisition in exchange for shares.

- It would seem inappropriate for the Act to deem a "surviving" affiliate to have disposed of any of its assets when the Act does not deem an affiliate to have disposed of any of its assets when it carries out a direct asset acquisition in exchange for shares.

• Efficiency and International Competitiveness. It is submitted that the Canadian tax consequences of a foreign merger should not depend on the foreign tax consequences of the merger. That is, even if the Act should continue to draw a distinction between foreign mergers based on the relevant taxpayer's percentage interest in the particular affiliate(s), it is submitted that this should be the only basis of distinction, and no additional conditions should be imposed under proposed paragraph 95(2)(d.1), especially not conditions based on the application of foreign law.

- It is our submission that the Canadian tax consequences of a foreign merger should be determined with reference to the circumstantial context in which it occurs, and not as a function of its foreign tax consequences. Other countries may have other priorities, and certainly would not have the international competitiveness of Canadian multinationals as a priority. Thus, the foreign tax rules do not necessarily reflect Canadian principles and priorities, and therefore should not be determinative of Canadian tax consequences.[13]

- If a particular foreign merger results in the imposition of foreign tax, it may be desirable for the taxpayer to elect to also recognize some income or gain for Canadian tax purposes, in order to utilize that foreign tax. This is a context in which it would perhaps be useful to maintain a distinction between proposed paragraphs 95(2)(d) and (d.1). The former could apply to produce a rollover at the asset (and shareholder) level, and the latter could permit taxpayers to elect to recognize some income or gain. Where a taxpayer elects to do so, that income or gain could be subjected to the same treatment as any income or gain arising from an "internal disposition", as described above, producing "suspended surplus" (treated like taxable surplus), or exempt surplus, in the case of a capital gain, on the condition of FAPI recognition for the taxable portion. Access to this elective regime could be restricted to circumstances in which the relevant taxpayer does not deal at arm's length with the particular affiliate(s), or in which the particular affiliate is a CFA.

- Another aspect of these Legislative Proposals which is troublesome in our view, as currently drafted, is that proposed paragraph 95(2)(d) does not provide for broad entity and attribute continuity. Thus, where a predecessor ceases to exist as a result of a foreign merger, nothing continues all the accounts and other attributes of the predecessor in the "successor".

- Recommendations. In summary, it is submitted that the foreign merger rules in proposed paragraphs 95(2)(d) and (d.1) should be revised in accordance with the following principles:

  - Paragraph 95(2)(d) should apply in respect of all taxpayers, regardless of their percentage interest in the particular affiliate(s), and should provide an asset-level rollover for both excluded property and non-excluded property, regardless of the foreign tax consequences, if any, of the merger. At a minimum, paragraph 95(2)(d) should not provide for any deemed disposition of the property of corporation that "survives" the merger.

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[13] For example, while we rely to some extent on foreign tax rules to compute earnings from carrying on an active business, this is not the case for FAPI, and even in the context of computing active business income we make certain adjustments under Regulation 5907(2) and other provisions.

- Paragraph 95(2)(d.1) should permit voluntary income or gain recognition both at the asset and at the shareholder level. Access to such elective income or gain recognition could be restricted to circumstances in which the taxpayer is not dealing at arm's length with the particular affiliate or where the affiliate is a CFA.

- Any such voluntary income or gain would be subject to the "suspended surplus" rules, as described above, producing "suspended surplus" (treated like taxable surplus), or exempt surplus, in the case of a capital gain, on the condition of FAPI recognition for the taxable portion.

- Paragraph 95(2)(d) should also provide for broad entity and attribute continuity.

We would also draw your attention to the more technical points we raise in relation to foreign mergers as set out in the Appendix hereto.

Foreign Liquidations

Many of the comments made above would be equally applicable in the context of the rules governing foreign liquidations. In particular, we refer to our comments on access to the asset-level rollover for non-excluded property in respect of taxpayers who may not have a 90% SEP in respect of the particular affiliate(s).

However, a number of additional concerns arise in relation to the proposed amendments to subsection 88(3), applicable to liquidations directly into Canada. There are three main areas of concern here.

- The recognition of FAPI on the distribution of excluded property.

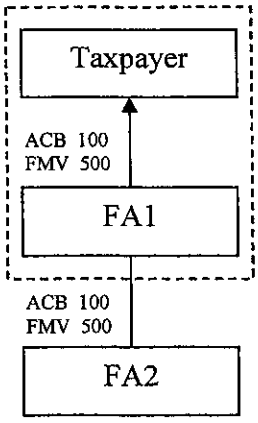
- The timing of surplus recognition and availability.

- The release of "suspended income or gain" pre-existing the liquidation.

As a matter of general principles, and the application of section 69, the liquidation and dissolution of a foreign affiliate would normally result in the realization of any accrued income or gain in respect of the property of the liquidating affiliate and in respect of its outstanding shares, determined as a function of the relevant proceeds of disposition, in turn determined as a function of relevant fair market values. In certain circumstances, however, it is considered to be appropriate to provide relief against income or gain recognition, in view of the "formalistic" nature of the transaction, or based on other relevant considerations.

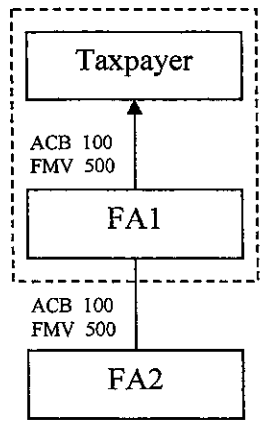
It is respectfully submitted that the following principles could serve as appropriate guideposts in formulating revisions to these very important rules in subsection 88(3), as they apply in the context of a liquidation:

- FAPI should never arise from the distribution of shares of another foreign affiliate of the taxpayer that constitute excluded property, even where the taxpayer elects that the liquidating affiliate's proceeds of disposition be increased above its ACB in the distributed property. There is one very compelling reason for this – namely, that, as a result of this election, the taxpayer's proceeds of disposition of its shares in the liquidating affiliate will increase immediately and in the same amount as the liquidating affiliate's proceeds are increased, such that the relevant gain will be "recognized" immediately and directly in Canada without recourse to the attribution of any FAPI. In brief, FAPI attribution is not necessary because the gain will in any event be "recognized" immediately and directly in Canada. Consider the following examples:



	FAPI on Gain	No FAPI on Gain
PROCEEDS (with RBC election)	500	500
FAPI resulting	200	nil
92 ACB Adjustment	200	nil
ES resulting	200	200
TS resulting	200	200
GAIN on FA1 Shares before 93(1)	400	400
GAIN of FA1 shares after 93(1) at 400	nil	nil
ES dividend	200	200
TS dividend	200	200
91(5) deduction	200	nil
Taxable Income	**200**	**200**
RESULTING ACB in FA2	500	500

As this example clearly illustrates, FAPI attribution on the gain resulting from the RCB election does not in any way increase the taxable income of the taxpayer. Therefore, this measure cannot be justified as a means of appropriately protecting the Canadian tax base. The real issue is whether or not taxpayers should be permitted to achieve even "better" consequences than those illustrated above. There are two examples we would consider to be relevant in this regard, each assuming that no FAPI would arise on the gain resulting from the RCB election, as follows:



	Case A	Case B	Case C
PROCEEDS (with RCB election)	500	500	500
ES resulting	200	200	200
TS resulting	200	200	200
GAIN on FA1 Shares before 93(1)	400	400	400
93(1)	nil	200	400
ES dividend	nil	200	200
TS dividend	nil	nil	200
TAXABLE GAIN on FA1 shares after 93(1)	200	100	nil
Taxable dividends	nil	nil	200
Taxable Income	200	**100**	200
RESULTING ACB in FA2	500	500	500

As this example clearly illustrates, the only circumstance in which there can be a concern from the Crown's perspective is where the taxpayer is permitted to "cherry-pick" the surplus arising from the gain resulting from the RCB election (Case B above). If a 93(1) election is not made at all (Case A above), the tax consequences are appropriate, in that the taxpayer recognizes a gain of 400, and taxable income of 200. If a 93(1) election in an amount no less than the gain resulting from the RCB election is made (Case C above), again the tax consequences are appropriate, in that the taxpayer recognizes no gain but has taxable income of 200 resulting from a deemed taxable surplus dividend. Only where the taxpayer makes a 93(1) election equal to the exempt surplus resulting from the RCB election (Case B above) is there any concern from the Crown's perspective, but only to the extent that the taxpayer effectively doubles-up on the exempt portion of the capital gain.

Thus, in order to address this concern, it is our recommendation that a taxpayer making a subsection 93(1) election in the context of a liquidation to which subsection 88(3) is applicable be required to elect an amount which is not less than the lesser of:

(a) the capital gain that the taxpayer would realize from the disposition of the shares of the liquidating affiliate if no such election were made, and

(b) the entire amount of any capital gain resulting from a RCB election made in connection with the liquidation.

This would fully address the Crown's concern without subjecting taxpayers to inordinate and inappropriate taxation. In our submission, taxpayers should be permitted to recognize gains resulting from RCB elections in respect of excluded property as capital gains, and taxable capital gains, rather than as attributed FAPI. Capital gains can be offset with capital losses which taxpayers may have, but attributed FAPI cannot be offset with capital losses. In addition, capital gains result in additions to a corporate taxpayer's capital dividend account, whereas FAPI does not. These are very important pillars of the Canadian income tax regime (the ability to offset capital losses against capital gains and the ability for a private corporation to distribute the exempt portion of its capital gains on a tax-free basis through its CDA), and should not be undermined under the Legislative Proposals.

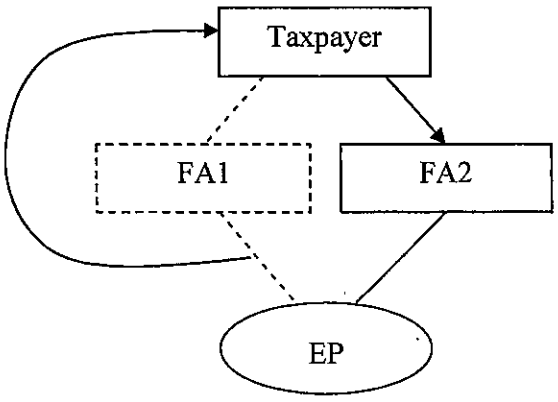
- The distribution of appreciated property other than excluded property to a taxpayer resident in Canada should be permitted to occur on a non-recognition or "rollover" basis. For this, too, there is one very compelling reason – namely, that non-recognition treatment results in the "importation" of a latent gain (or income) which, when the relevant property is subsequently disposed of in a recognition transaction, will result in taxable income under the Act. In other words, it seems inappropriate to deny a rollover where the gain in question is being shifted into the Canadian tax net. After all, the very purpose of the FAPI regime is to bring into the Canadian tax net what would otherwise be

outside its parameters. By bringing the property directly into Canada on a rollover basis, the taxpayer has permanently conceded taxing jurisdiction in respect of the latent gain to Canada. Moreover, since rollover treatment in this context results in the "importation" of latent gain, and therefore cannot adversely affect the Crown, it is our view that it should be permitted regardless of the taxpayer's percentage interest in the liquidating foreign affiliate.

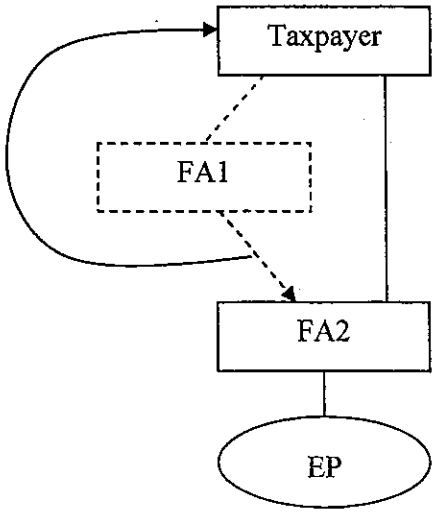
- The timing rules applicable in this regard for surplus computation purposes should be structured so that they clearly permit the use, pursuant to subsection 93(1), of surplus arising from dispositions that occur in the course of the liquidation. This is the case in our view under the current version of Regulation 5907(9), but may not be the case under proposed Regulation 5907(9) as currently worded. Moreover, assuming that this concern were addressed (for example, by adding a timing rule into proposed Regulation 5907(9)(b)(i) deeming the disposition to have occurred "immediately before the end of the affiliate's taxation year deemed to have ended by paragraph (a)", like the rule under current law), it would also be necessary to ensure that the resulting surplus would be available under subsection 93(1).

- The final liquidation and dissolution of a foreign affiliate should release any "suspended" income or gain it may have, such that these items may be taken into account for final surplus computation purposes as described above. If these "suspended" items are not released at this time, they will be lost, which is inappropriate. More importantly, however, we note that since income and gains are not and should not be "suspended" where they arise from dispositions resulting from liquidation distributions into Canada, the liquidation of a foreign affiliate should release any of its "suspended" income or gains. Consider the following comparison:

<u>Case A</u>



<u>Case B</u>



In Case A, FA1 distributes excluded property to the taxpayer on its final liquidation, thereby realizing all accrued income and gains, and corresponding surplus, which is available for subsection 93(1) purposes. The cost to the taxpayer of the property equals its value, and the taxpayer does not realize any taxable income or capital gain from the disposition of its FA1 shares because a subsection 93(1) election is made (this assumes the taxpayer's ACB of its FA1 shares was not less than FA1's ACB and other cost of its property). The taxpayer then transfers the property to FA2, in exchange for shares of FA2, resulting in the taxpayer having ACB equal to value in the FA2 shares, and FA2 having ACB and other cost equal to value in the underlying property. Arguably, it should be possible to achieve the same results and tax attributes in Case B, where the order of steps is simply reversed but the corporate and commercial result is identical. That is, FA1 first transfers the property to FA2, then distributes the FA2 shares to the taxpayer on its liquidation. Any "suspended" income or gain that arose on the preliminary transfer to FA2 should be released and be available on the liquidation of FA1 in the same manner as it would be if such income and gain had been realized on the liquidation as such rather than on the preliminary transaction.

We would also draw your attention to the more technical points we raise in relation to foreign liquidation as set out in the Appendix hereto.

Distributions

The Legislative Proposals would substantially expand the circumstances in which corporate property can or must be distributed to its shareholders on a non-recognition or rollover basis outside of the context of a liquidation of the distributing corporation. More specifically, new rules would be introduced governing the distribution of the property of a foreign affiliate by way of a dividend or other distribution in kind, or on the redemption, acquisition or cancellation of a share of the distributing affiliate, whether into Canada (as contemplated by proposed subsection 88(3)) or to another foreign affiliate of the relevant taxpayer (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)).

In general terms, a fair market value disposition would be prescribed in respect of distributions into Canada (as contemplated by proposed subsection 88(3)), except in respect of the distribution of shares of another affiliate that constitute excluded property, unless an RCB election is made, as discussed above in the context of liquidations. In the foreign-to-foreign context (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)), rollover treatment would be prescribed in respect of dispositions of excluded property (with FAPI treatment for any income or gain resulting from an RCB election), and a fair market value disposition would be prescribed in respect of distributions of non-excluded property.

As noted above, it is our view that such a bias is inappropriate in this context. The rules should be even-handed as between distributions of excluded property and non-excluded property (that is, a rollover should be available in either case), although we would understand that income

and gains resulting from RCB elections in this context from foreign-to-foreign dispositions of excluded property could in some cases be subjected to "suspended surplus" treatment as described above. Indeed, it seems somewhat curious that a rollover would be available for non-excluded property distributed on a liquidation governed by proposed paragraph 95(2)(e.1), but not available in respect of the same property distributed to the same shareholder by way of a dividend in kind governed by proposed paragraph 95(2)(e.3).[14]

It is respectfully submitted that these proposed amendments should be structured in a manner which is consistent with the following principles, in addition to those articulated above in relation to internal dispositions and liquidations:

- As a default, property distributed by a foreign affiliate to the taxpayer (as contemplated by subsection 88(3)), that constitutes shares of another foreign affiliate of the taxpayer (or of a corporation that would as a result of the distribution become another foreign affiliate of the taxpayer), should be deemed to be disposed of at its cost amount, regardless of whether or not the shares are excluded property. The taxpayer should be permitted to make a RCB election, and any income or gain that results therefrom should give rise to a FAPI inclusion only if the property is not excluded property. Any such income or gain should not be "suspended" for surplus computation purposes. If the property is distributed by way of a dividend in kind (including deemed dividends), there is no concern with respect to the taxpayer "cherry-picking" the exempt surplus resulting from the RCB election, because the amount of the dividend will increase in the same amount as the distributing affiliate's proceeds are increased by the RCB election.[15] If the property is distributed on a redemption, acquisition or cancellation of shares of the distributing affiliate, or as a return of capital, and the taxpayer makes a subsection 93(1) election, this "cherry-picking" concern does not really arise in the same way because current-year surplus cannot be used in the context of a subsection 93(1) election (except on a liquidation)[16] and, in any event, can be addressed at least in part by requiring the taxpayer to elect an amount which is not less than the lesser of the gain resulting from the RCB election and the gain otherwise resulting from the disposition of the shares of the distributing affiliate, as noted above.

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[14] The same can be said in respect of distributions governed by subsection 88(3) – that is, that it seems somewhat curious that a rollover would be available for non-excluded property distributed on a liquidation governed by proposed paragraph 95(2)(e.1), but not available in respect of the same property distributed to the same type of shareholder in the context of a transaction governed by subsection 88(3), be that a liquidation or other distribution.

[15] It should be noted that the dividend would be considered to have been paid out of surplus arising from the RCB election only to the extent that the dividend is paid after the first 90 days of the affiliate's taxation year, in accordance with Regulation 5901(2).

[16] See Regulations 5901(2) and 5907(9).

- As for the amount and character of the dividend, distribution or proceeds from the Canadian taxpayer's perspective, we would make the following recommendations:

  - All amounts should be determined as a function of the deemed proceeds of disposition of the distributed property to the distributing affiliate.

  - Amounts distributed legally as dividends in kind should be characterized as dividends.

  - Amounts distributed legally other than as dividends in kind or redemption or other disposition proceeds (i.e., distributions in the form of returns of capital or other legal distributions of property) should be characterized as returns of capital to the extent that the recipient is recovering the cost of its investment – that is, to the extent of the ACB to the recipient of the shares of the distributing affiliate on which such distributions are made – with any excess being characterized as a dividend (and, in turn, as an exempt surplus, taxable surplus or pre-acquisition surplus dividend, in accordance with applicable ordering rules).[17] This approach would permit a shareholder to recover its actual cost of an investment, but would not permit the legal capitalization of retained earnings to be extracted as capital gains. To be clear, it is our view that legal distributions (as opposed to improper appropriations) exceeding the amounts treated as returns of capital should result in deemed dividends, and not result in non-dividend income to the taxpayer or any subsection 15(1) or similar benefit inclusion.

  - Finally, redemption or other disposition proceeds should be characterized as such, except to the extent that a subsection 93(1) election is made.

- Similar principles should be applicable in the context of foreign-to-foreign distributions to specified purchasers (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)), subject to the following:

  - Income and gains resulting from a RCB election in respect of excluded property should not result in FAPI attribution, but rather in "suspended surplus" as described above, treated in the same manner as taxable surplus unless and until a

[17] Moreover, we understand that the Department is presently considering the adoption of a specific definition of "paid-up capital" which would be applicable for these purposes (and which we will refer to as "foreign paid-up capital" or "FPUC"), and that this definition would include all amounts contributed to a corporation by a shareholder or as consideration for the issuance of its shares (whatever the designation of those amounts may be for foreign corporate law purposes, be it "share premium", "contributed surplus" or some other designation). We believe the cost-recovery approach suggested above would be a simpler and more appropriate approach in these circumstances.

relevant release event occurs – unless the taxpayer elects FAPI treatment.[18] Moreover, it seems inappropriate, and not even-handed, for the proposed description of B in the definition of FAPI to continue to include a portion of gains arising from the disposition of excluded property in certain reorganization circumstances, when the proposed description of E in the definition of FAPI is being amended to specifically exclude losses arising from the disposition of excluded property in such circumstances.

- Redemption or other disposition proceeds should be characterized as such, except to the extent that a subsection 93(1) election is made or is deemed to be made in accordance with proposed subsection 93(1.1).

- Taxpayers should be permitted to suppress the recognition of gains arising in respect of shares that are not excluded property and which arise in respect of a transaction governed by proposed paragraph 95(2)(e.3) to (e.5), whether by reason of the application of subsection 40(3) or otherwise.

- Gains arising in respect of shares that are excluded property, whether by reason of the application of subsection 40(3) or otherwise, should simply be subjected to the "suspended surplus" rules described above.

We would also draw your attention to the more technical points we raise in relation to foreign distributions as set out in the Appendix hereto.

Surplus Adjustments and Subsection 93(1) Elections

The Legislative Proposals introduce a number of significant changes to the provisions that determine when and to what extent the surplus balances of an affiliate, or group of affiliates, whose shares are disposed of, may be accessed, other than by paying dividends, in accordance with subsection 93(1). These proposals limit the amount of a subsection 93(1) election to the lesser of the proceeds of disposition of the disposed share and the amount "prescribed", determined by reference to a new "consolidated net surplus" regime. This new regime is intended essentially to offset available surplus by the amount of any deficits in the relevant foreign affiliate chain. In addition, a new adjustment rule would reset the surplus, deficit and underlying foreign tax balances of the relevant affiliates in the event that a subsection 93(1) election is or is deemed to be made in respect of most internal dispositions, and another rule would adjust the ACB of the relevant inter-affiliate shareholdings for certain purposes to reflect these resets and adjustments.

[18] This would also address a concern which has been raised relating to the permanent disappearance of surplus where excluded property is distributed to a non-resident shareholder in which the taxpayer has no direct or indirect equity interest, if the distribution occurs on a rollover basis.

Amount of Election – Proposed Regulation 5902(1)

Under the current rules, where subsection 93(1) applies in respect of the disposition of the shares of a particular affiliate, the surplus of the affiliate is determined by assuming that each other affiliate in which the particular affiliate had an equity percentage had paid dividends on its shares equal to its net surplus, seriatim beginning with the lowest-tier affiliate. Where the disposed affiliate is in a corporate chain including affiliates with deficit accounts (positioned above affiliates with surplus balances, such "blocking deficits" offset the surplus balances in the course of the hypothetical upwardly cascading distributions. However, where the corporate chain includes affiliates with deficit accounts positioned below or level with affiliates with positive surplus balances (what might be referred to as "dangling deficits"), the deficit accounts do not offset the surplus balances. In contrast, under the proposed amendments to Regulation 5902(1), surplus will be consolidated with deficits in all cases to produce "consolidated exempt surplus", "consolidated exempt deficit", "consolidated taxable surplus", "consolidated taxable deficit" and "consolidated net surplus".

More specifically, where a subsection 93(1) election is or is deemed to be made by a taxpayer, the amount prescribed, for purposes that subsection in respect of the disposed share is not to exceed the amount that would be received on that share immediately before the disposition if the disposed affiliate paid a dividend at that time on all of its shares, the total of which is equal to its consolidated net surplus in respect of the taxpayer immediately before the dividend time. The disposing affiliate's consolidated net surplus is defined to be the amount, if any, by which the total of the disposing affiliate's exempt and taxable surplus exceeds the total of the its exempt and taxable deficits, all computed in respect of the taxpayer. The disposing affiliate's consolidated exempt surplus is the total of its own exempt surplus and its proportionate share of the exempt surplus of each underlying affiliate in which it has a direct or indirect equity percentage. For this purpose, the exempt surplus of each affiliate is determined on the assumption that the affiliate had no exempt deficit, no taxable surplus and no taxable deficit. The affiliate's consolidated taxable surplus, consolidated exempt deficit, consolidated taxable deficit, and consolidated underlying foreign tax are similarly determined. For purposes of determining the portion of the whole dividend arising from the subsection 93(1) elected amount that is, for example, prescribed to be paid out of the disposing affiliate's exempt surplus, such exempt surplus is deemed to the amount, if any, by which the affiliate's consolidated exempt surplus exceeds its consolidated exempt deficit, and so on. Consider the following example:

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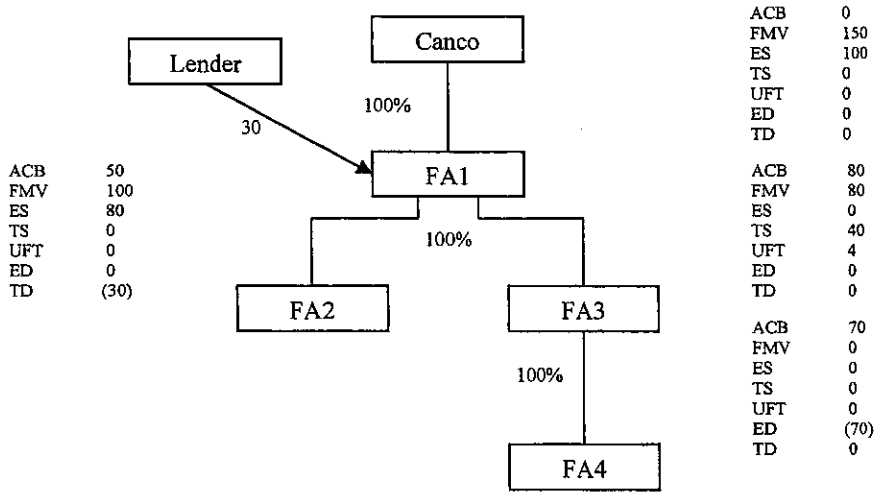
Example A



Assumptions:

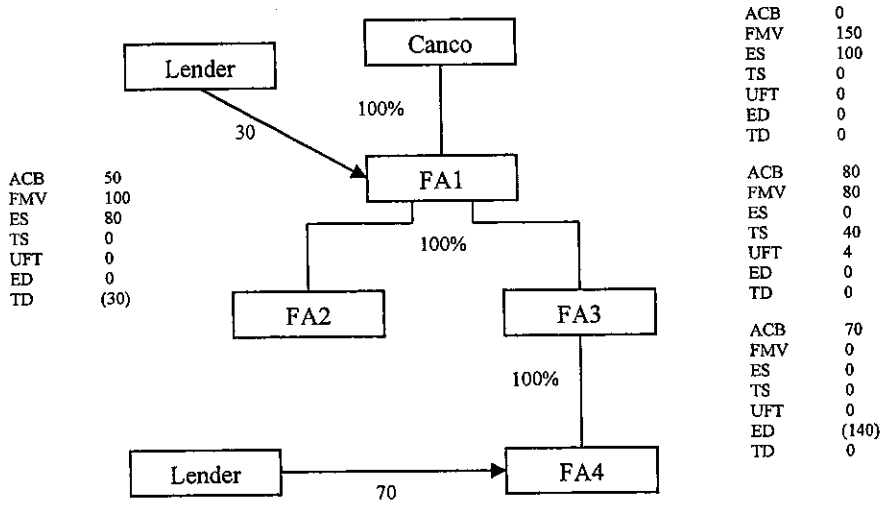
- Canco sells 100% of FA 1 (100 shares) to an unrelated non-affiliate for cash of $150.

Under the current rules, FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) ES of $150 (being its own ES of $100 and ES of $50 from FA2; (ii) TS of $40 from FA3; and (iii) UFT of $4, also from FA3. The ED of $140 in FA4 would be ignored, but the TD in FA2 would reduce its net surplus, and therefore its available exempt surplus. Under current Regulation 5902(1), Canco would presumably make a subsection 93(1) election of $150, all of which would be prescribed to be paid out of ES, and would have no resulting capital gain.

Under proposed Regulation 5902(1), FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) consolidated ES of $180 (being its own ES of $100 and ES of $80 from FA2); (ii) consolidated TS of $40 (from FA3); (iii) consolidated ED of $70 (from FA4); and (iv) consolidated TD of $30 (from FA2). FA1's consolidated net surplus would be $120 ($180 + $40 – $70 – $30), with the result that the amount of its "attributed net surplus" in respect of each disposed share (the "amount prescribed") would be $1.20. In total, the subsection 93(1) election would be limited to $120. For purposes of determining the surplus accounts out of which the deemed dividend would be prescribed to be paid, FA1 would be deemed to have ES of $110 ($180 - $70), TS of $10 ($40 - $30) and UFT of $4. Although all of the subsection 93(1) election amount of $120 would be fully deductible under subsection 113(1), the result under the proposed changes would be that Canco realizes a capital gain of $30.

Joint Committee's Comments

While the proposed amendments to Regulation 5902(1) may seem logical at a high level (for instance, in Example A, there is a $30 unrealized gain in the structure – in FA3 – and Canco realizes a capital gain of $30), they appear to suffer from at least one important flaw, namely the possibility of effectively attributing to a shareholder a portion of an affiliate's deficit which exceeds the shareholder's economic loss in respect of its investment in the affiliate. To illustrate this result, assume in Example A that FA4's deficit had been financed with $70 of borrowed capital from a 3rd Party lender. The facts would look as depicted below, the only differences being that FA4's ED is $140 rather than $70 and it has borrowed capital of $70:



In such a case, FA3's economic loss in respect of its investment in FA4 would still be $70 (like in Example A), but under the Legislative Proposals $140 of ED would be attributed. That is, under proposed Regulation 5902(1), FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) consolidated ES of $180 (being its own ES of $100 and ES of $80 from FA2); (ii) consolidated TS of $40 (from FA3); (iii) consolidated ED of $140 (from FA4); and (iv) consolidated TD of $30 (from FA2). FA1's consolidated net surplus would be $50 ($180 + $40 – $140 – $30), with the result that the amount of its "attributed net surplus" in respect of each disposed share (the "amount prescribed") would be $0.50. In total, the subsection 93(1) election would be limited to $50. For purposes of determining the surplus accounts out of which the deemed dividend would be prescribed to be paid, FA1 would be deemed to have ES of $40 ($180 - $140), TS of $10 ($40 - $30) and UFT of $4. Although all of the subsection 93(1) election amount of $50 would be fully deductible under subsection 113(1), the result under the proposed changes would be that Canco realizes a capital gain of $100. This result is inappropriate because there is still only a $30 unrealized gain in the structure – in FA3. Thus, Canco is being taxed on a "phantom gain" – that is, a gain that does not exist.

Viewed from a slightly different perspective, it is submitted that it would be inappropriate for more than $70 of FA4's deficit to be attributed to FA3, and then to FA1. However, the test under the Legislative Proposals is based on the amount that FA3 would receive from FA4 if FA4 paid a dividend equal to its "consolidated exempt deficit". The fact that this amount could exceed FA3's true economic loss does not enter into the equation. Thus, the proposed amendments over-attribute lower-tier deficits to higher-tier affiliates. Such untoward effects may, in appropriate cases, be avoidable[19] - but, arguably, should not arise in the first place. The structural flaw in this regard in the Legislative Proposals would appear to arise because of the fallacy that shareholders participate in profits to the same extent that they participate in losses. This is false in the case of shareholders of a limited liability company – indeed, that is the entire point of limited liability – to permit shareholders to participate in unlimited economic "upside" with limited exposure to economic "downside". Moreover, even if a shareholder has guaranteed the company's obligations, there is no structural need to attribute deficit on the shares in an amount exceeding the economic loss on the shares, since the shareholder should have a loss on the guarantee. Similarly, if deficit is attributed on the shares in an amount exceeding the economic loss on the shares because of a guarantee, such over-attribution should never exceed the amount guaranteed, and provision should be made to ensure that the shareholder's loss on the guarantee does not result in deficit duplication. Surely, we should be as concerned about deficit duplication as we are about surplus duplication – even-handedness.

Other aspects of this approach also seem to be capable of producing inappropriate results. To illustrate, in Example A, while it is clear that there has been a loss of $70 (the $70 that was invested in FA4), it is not clear that this loss ought to be considered to have eroded any of the exempt surplus in the chain – that would be the case to the extent that the $70 investment in FA4 was funded with a reinvestment of ES earned by FA3, but not the case to the extent that the $70 investment in FA4 was funded with a reinvestment of TS earned by FA3. In Example A, the proposed amendments would seem to allocate the $70 loss against ES as to $40 (reducing the ES dividend from $150 to $110), and against TS as to $30 (reducing TS from $40 to $10). These are not necessarily the appropriate amounts.

These flaws are inherent in the structural mechanics of determining consolidated net surplus, which includes all deficits within the group of relevant affiliates regardless of where in the group the deficits are located or how they are financed. The result is different than the result that would be obtained if dividends where paid up the chain of affiliates. In this respect, the proposed amendments represent a fundamental change to what subsection 93(1) was originally enacted to accomplish, which was to be a proxy for an actual dividend that could be paid up the chain (in Example A, from FA2, FA3 and FA4 to FA1 and then to Canco). As is evident from Example A, that may no longer be the case. Canco could eliminate the capital gain of $30 that would otherwise arise as a result of the proposed amendments if immediately prior to the sale of

[19] For example, it may be possible in certain circumstances to avoid such over-attribution of "dangling deficits" by first selling affiliates that have deficits exceeding the relevant economic loss.

the FA1 shares, FA2 paid a dividend to FA1 from exempt surplus of $50 followed by a dividend of $150 from FA1 to Canco. This would presumably reduce Canco's proceeds on the sale of the FA1 shares and the capital gain. No Canadian tax would therefore be exigible, which is the result under the current rules, but the dividends from FA2 and FA1 could potentially be subject to foreign withholding tax. In this sense, this proposal would seem to put Canadian multinationals and the Canadian economy in a disadvantageous position, in that it would create an incentive to incur foreign withholding tax to the extent that the amount of such tax would be lower than the Canadian capital gains tax that would be payable if no dividend were paid. Surely, it cannot be in the interests of Canadians to create incentives for Canadian multinationals to incur foreign withholding tax costs – and this is the very foundation of subsection 93(1).

Applicability of a subsection 93(1) election

Subsection 93(1.4)

Pursuant to proposed subsection 93(1.4), no election can or will be deemed to be made under subsection 93(1) or (1.2) by a corporation in respect of the disposition of a share of a foreign affiliate if any of the specified provisions referred to in that subsection applies to the disposition. These are: paragraph 88(3)(a) and subparagraphs 95(2)(d)(i), (d.1)(i), (e)(i), (e.1)(i), (e.2)(i),[20] (e.3)(i), (e.4)(i) and (e.5)(i) (these subparagraphs are discussed above and in the Appendix hereto). Interestingly, neither paragraph 95(2)(c) nor proposed paragraph 95(2)(c.2) is mentioned (these paragraphs are also discussed above and in the Appendix hereto).

The purpose of subsection 93(1.4) seems to be to permit the subsection 93(1) election in respect of dispositions at the shareholder level (indeed, to require it where subsection 93(1.1) applies – where the disposition is by a foreign affiliate of a corporation), but not at the level of corporate assets disposed of in the context of a foreign merger, liquidation or distribution.[21]

Subsection 93(1.1)

The Legislative Proposals expand subsection 93(1.1) such that it will apply whenever shares of a foreign affiliate of a corporation resident in Canada are disposed of by another foreign affiliate of the corporation, whether or not the shares constitute excluded property. The proposed amendment would also eliminate the exclusion from subsection 93(1.1) in respect of dispositions to which any of paragraphs 95(2)(c), (d) or (e) applies. It would render subsection 93(1) applicable in all cases where a share of a foreign affiliate of a corporation is disposed of by another affiliate, subject to the limitations in proposed subsection 93(1.4) noted above.

Joint Committee's Comments

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[20] The reference to proposed subparagraph 95(2)(e.2)(i) would seem to be inadvertent.

[21] An exception is proposed paragraph 88(3)(a), which we understand is a drafting error.

Subsection 93(1.1) has been expanded to apply in every case where there is a disposition of shares of a foreign affiliate held by another affiliate. This provision was intended to prevent taxpayers from converting undistributed taxable surplus into capital gains, with consequent surplus apportionment. If it is appropriate in policy terms to extend the application of this rule, on the basis that underlying surplus should always be apportioned to the same account at the shareholder affiliate level, then it seems difficult to understand why that would not be true in all cases. We are not clear on why subsection 93(1.4) is necessary or what purpose it serves.

The restrictions in subsection 93(1.4) on the application of subsection 93(1) seem to relate to assets of a merging, liquidating, distributing affiliate. We are not clear on why this is necessary. What if the property being distributed is shares of another FA, and there is no disposition of the shares of the distributing affiliate on that distribution? Moreover, even where the distribution results in a disposition of the shares of the distributing affiliate, it seems inappropriate to preclude a subsection 93(1) deemed dividend with respect to distributed property – i.e., shares of another affiliate, since those shares will not be owned by the distributing affiliate at the time of the disposition of the shares of the distributing affiliate, such that the underlying surplus will be completely unavailable.

It is submitted that proposed subsection 93(1.4) should be withdrawn.

Post-Election Adjustments – Proposed Regulations 5902(3) and 5905(2), (4), (5) and (8)

Apart from an additional reference to Regulation 5902(4), Regulation 5902(3) is essentially unchanged, and therefore continues to preclude an adjustment to surplus in respect of a subsection 93(1) deemed dividend, except as provided in Regulations 5905(2), (4), (5) and (8).[22] These latter provisions govern adjustments to be made in respect of certain redemptions, cancellations or acquisitions of foreign affiliate shares, certain foreign mergers involving affiliates, certain Canadian transactions involving interests in foreign affiliates, and certain other dispositions to other foreign affiliates or related persons. The revisions to each of these provisions are substantially similar, and are discussed immediately below in the context of Regulation 5905(8) – sale of shares of a foreign affiliate to another foreign affiliate.

Current Approach

Under the current rules, where a subsection 93(1) deemed dividend arises in respect of a relevant sale of shares, Regulation 5905(8) makes corresponding adjustments to the surplus accounts of the affiliate whose shares were disposed of, which could result in such accounts becoming a deficit, but no adjustments are made to the accounts of any lower-tier affiliates, even though the amount of the deemed dividend would reflect the attribution of their exempt and taxable surplus. This is not an illogical approach, and in fact has operated relatively well over a number of decades. It is appropriate for no adjustment to be made to the accounts of lower-tier

[22] The reference to Regulation 5905(5) should probably be a reference to Regulation 5905(6).

affiliates because the value which corresponds to the lower-tier surplus taken into account at the top tier has not in fact been extracted, and remains within the lower-tier affiliates. That lower-tier surplus will also be required in the future in order to in fact distribute that value without eroding the ACB of the shares of the relevant lower-tier affiliates.

However, it is understood that the Department of Finance had perceived concerns with respect to this "separation" of surplus and corresponding deficit, and accordingly is proposing to introduce a more comprehensive and complex "balance adjustment" mechanism under revised Regulation 5905, which would produce adjustments at all relevant tiers.

Proposed Approach

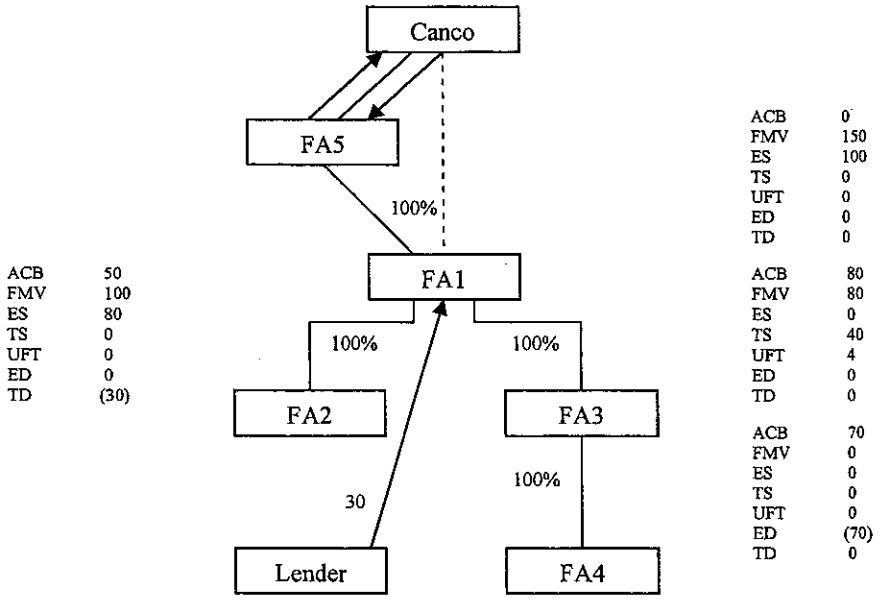
Proposed regulation 5905(8)(a) will essentially require the exempt surplus portion of the 93(1) elected dividend amount to be allocated (through an "exempt surplus reduction" amount) proportionately to, and reduce the ES of, each foreign affiliate in the relevant chain that had a balance of exempt surplus at the dividend time. The proportionate amount for a particular affiliate is determined by the formula A/B, where A is the particular affiliate's ES that can reasonably be considered to have been included in the consolidated ES of the affiliate whose shares were disposed of (such affiliate is referred to as the "issuing affiliate"), and B is the issuing affiliate's consolidated ES.[23] Proposed regulation 5905(8)(a) will require the taxable surplus portion of the elected amount to be allocated (through a "taxable surplus reduction" amount) proportionately to each foreign affiliate in the relevant chain that had a balance of taxable surplus in a manner similar to the ES allocation.

When a subsection 93(1) election is made on the internal sale of a FA share, Regulation 5905(8)(a) will reduce the exempt and taxable deficit of an affiliate in the chain to *nil*, and will require a corresponding proportionate reduction in the exempt and/or taxable surplus balances for those affiliates in the chain that have exempt and/or taxable surplus balances. If the issuing affiliate had consolidated ES in excess of its consolidated ED, the exempt deficits that are eliminated will be allocated (through "exempt deficit reduction" amounts) proportionately to those affiliates that had a balance of ES. If the issuing affiliate had, for example, consolidate ED in excess of its consolidated ES, each affiliate that had a balance of ES will have that balance reduced to *nil* (through the "exempt deficit reduction" amounts), and the excess of the issuing affiliate's consolidated ED over its consolidated ES will be allocated (through "exempt deficit

[23] The proportionate amount so determined is then adjusted for a specified adjustment factor for the particular affiliate. This factor is determined by the formula X/Y, where X is (a) where Canco disposed of the shares, 100%, and (b) when another affiliate disposed of the shares, the surplus entitlement percentage ("SEP") of Canco in that other affiliate immediately before the disposition; and Y is Canco's SEP in the particular affiliate immediately before the disposition.

allocation" amounts) proportionately to those affiliates that had a balance of TS. Similar rules apply to the allocation of TDs that are reduced to *nil*.[24]

Example B



Assumptions:

- Canco sells 100% of FA 1 (100 shares) to FA5 for cash of $120 and shares of FA5, and Canco makes subsection 93(1) election for $120.

As noted in Example A, for purposes of subsection 93(1) under current rules, FA1 would be deemed to have ES of $150, TS of $40 and UFT of $4. A subsection 93(1) election of $120 would result in a dividend prescribed to be paid solely out of ES, and FA1's $100 of ES would become an exempt deficit of $20, and no adjustment would be made to the surplus accounts of FA2, FA3 or FA4. Thus, on a "consolidated basis", the FA1/FA2/FA3 group would have (net) ES of only $30 and (net) TS of $40, which would be appropriate. The fact that FA2 would still have $50 of (net) ES would also be appropriate, because FA2 would still have the value corresponding to that ES, and would need that ES in order to be able to pay a dividend to FA1 equal to $50 without eroding FA1's ACB in FA2. Once that dividend is paid, the $20 blocking deficit in FA1 would result in FA1 having ES of $30, which again is appropriate. In a similar

[24] If the issuing FA had consolidated TD in excess of consolidated TS, the excess would be proportionately allocated to, and reduce, the other affiliates' ES through the "taxable deficit allocation" amounts.

vein, when FA3 pays a $40 TS dividend to FA1, it will result in FA1 having ES of $30 and TS of $40 (as well as UFT of $4), which again is appropriate

As indicated in Example B, under the proposed rules, the subsection 93(1) elected dividend amount of $120 would be prescribed to be a $110 ES dividend and a $10 TS dividend, and the following adjustments would be made:

- The $110 ES portion would be allocated proportionately between FA1 and FA2. FA1's consolidated ES is $180 and consists of FA1's ES of $100 and FA2's ES of $80. FA1's proportions of the consolidated ES is 55% (100/180) and FA2's proportion is 45% (80/180). The $110 ES dividend amount would be allocated $61 to FA1 and $49 to FA2, and reduces the ES of these affiliates accordingly (these reductions are the "exempt surplus reduction" amounts).

- The TS portion ($10) of Canco's subsection 93(1) elected amount ($120) would be allocated solely to FA3, and would be the "taxable surplus reduction" amount for FA3.

- The $70 ED of FA4 would be reduced to *nil*.

- Since FA1 had a "consolidated exempt deficit" of $70, and had consolidated ES in excess of this amount, this deficit is "allocated" proportionately to FA1 and FA2 (55%, or $39, to FA1, and 45%, or $31, to FA2), and these amounts are the "exempt deficit reduction" amounts to FA1 and FA2.

- Similarly, the $30 TD of FA2 would be reduced to *nil*, and since the consolidated TS of FA1 exceeds its consolidated TD, FA2's TD of $30 would be allocated to FA3 through the "taxable deficit reduction" amount.

- In summary, FA1's ES of $100 would be reduced to *nil* (by the $61 exempt surplus reduction amount and the $39 exempt deficit reduction amount. FA2's ES of $80 would be reduced to *nil* (through the $49 exempt surplus reduction amount and the $31 exempt deficit reduction amount). FA3's TS of $40 would be reduced to *nil* (through the $10 taxable surplus reduction amount and the $30 taxable deficit reduction amount). FA2's TD of $30 and FA4's ED of $140 would also be reduced to *nil*.

Joint Committee's Comments

As noted, we understand that the proposals described above are intended to mitigate possible abuses of the current rules where, as a result of a 93(1) election, a deficit is created within a group of affiliates that is subsequently avoided or eliminated resulting in the effective duplication of, in particular, exempt surplus.

The Committee submits that these perceived concerns would largely be addressed by the proposed revisions to Regulation 5905(7) concerning the elimination of blocking deficits on the

liquidation of an affiliate, and that the addition of these added measures will introduce a significant degree of unnecessary complexity into the foreign affiliate rules, and unnecessarily increase the compliance burden on taxpayers, as well as the administrative burden on the Crown. Further, these proposals, and those discussed below, include a number of significant structural and technical deficiencies.

As a result of these proposals, a subsection 93(1) election could change the make-up of the surplus accounts within a particular group of affiliates in ways that, unlike under the current system, may not be particularly intuitive, or particularly appropriate. In Example B, Canco extracted $120 of cash from FA5 free of Canadian tax, but the subsection 93(1) election of $120 reduced all surplus and deficit accounts of the relevant affiliates to *nil*. If Canco had transferred the FA1 shares to FA5 solely for shares, Canco could have subsequently extracted, free of Canadian tax, $150 of cash from FA5 through the actual payment of ES dividends ($50 from FA2; $100 from FA1). Moreover, in Example B, if Canco had only transferred one FA1 share to FA5 for cash of $1.20, and Canco made a subsection 93(1) election for the $1.20, the ES reduction amount for FA1 and FA2 would only aggregate $1.10, but the ED reduction amount to FA1 and FA2 would still be the $70 amount noted above. As a result of a subsection 93(1) election of $1.20, for subsequent dividend purposes the combined ES of FA1 and FA2 would be reduced to $108.90. It is submitted that this result is completely inappropriate, and is an example of the structural deficiencies inherent in these proposals.

It should be noted also that there may be circumstances in which the proposed amendments would give rise to planning opportunities in this regard. Consider the following example.

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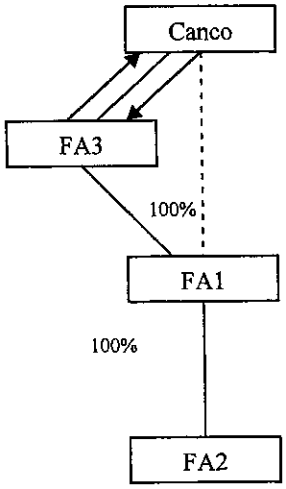
Example C



	Before	After
ACB	100	101
FMV	101	101
ES	0	0
TS	50	0
UFT	0	0
ED	0	0
TD	0	0

ACB	50	1
FMV	1	1
ES	0	0
TS	0	0
UFT	0	0
ED	(49)	0
TD	0	0

Assumptions:

- Canco transfers FA1 to FA3 for $101 cash, and Canco makes a subsection 93(1) election for $1 (deemed to be a TS dividend).

Under proposed regulation 5905(8)(a), FA2's ED of $49 would be reduced to *nil*, and would be applied against FA1's TS. If FA2 subsequently became profitable, ES dividends could immediately begin being paid out through FA2 and FA1. In contrast, if this "balance adjustment" transaction were not carried out, FA2 would have to first accumulate exempt earnings equal to its ED before any ES dividends could be paid by FA2.[25] Again, the structural aspects of these proposals give rise to results that would seem to be inappropriate.

Finally and perhaps most important, these proposed changes are exceedingly complex and are virtually impossible for taxpayers to understand. The complexity starts with the Department's proposal requiring the computation of consolidated net surplus for the relevant group and then requiring the surplus and deficit balances for each member of the group to be adjusted.[26] We refer to the presentation at the conference hosted by the Canadian Branch of the International Fiscal Association on May 10, 2004, during which the Department provided an example of the computation of consolidated net surplus and the adjustments that would need to be made to the surplus accounts of foreign affiliates in a hypothetical transaction. We refer also

[25] It should be noted also that there would be a downward adjustment to FA1's ACB in FA2 (for certain purposes), equal to the amount by which FA2's deficit has been reduced, in accordance with the rules in proposed subsections 92(1.1) to (1.4) and Regulation 5911. See the discussion below.

[26] A further complication, as discussed below, there is also a requirement to adjust the ACB of the shares of the affiliates in the group.

to the examples considered above. We submit that there would be few, if any, taxpayers, that would have been able to prepare such calculations in advance of such a transaction in actual practice, and therefore few, if any, that would have been able to understand or predict the effects that the 93(1) election would have on their affiliates' surplus accounts.

The uncertainty created by the proposed amendments in this regard arises not only because of the complexity of the provisions, but also because of structural aspects of the proposals. That is, because a subsection 93(1) election would require adjustments to be made in respect of the accounts of all relevant affiliates, not just the issuing affiliate, uncertainty or error with respect to the accounts of a single affiliate will have a cascading effect and could result in uncertainty and error throughout the entire group. This could result in significant problems in the context of a foreign affiliate reorganization in actual practice, and thereby compromise the competitiveness of Canadian multinationals.

Accordingly, it is our submission that this proposed measure be withdrawn. To be clear, it is not our submission that Regulation 5905 should not be updated, or that the various technical issues that exist in that regard should be ignored. For example, there does not appear to be any rule currently in Regulation 5905 that would account for a subsection 93(1) election made in the context of a foreign merger, with the result that surplus can be duplicated in that context. Moreover, there are significant issues relating to the determination of a taxpayer's surplus entitlement percentage under Regulation 5905. There is also no rule that would preserve a deficit in the context of a liquidation of one foreign affiliate into another. These and similar issues should be addressed, but it does not follow that the fundamental architecture of the regime reflected in this regulation should be reoriented.

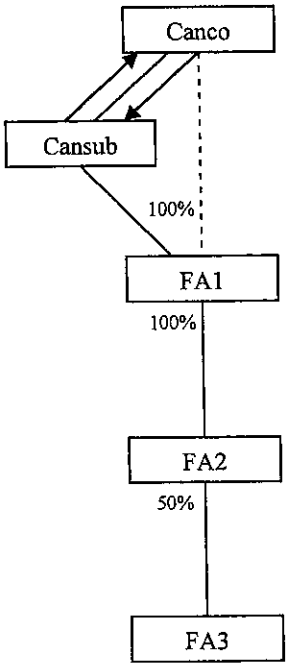
Parallel Regimes – Proposed Regulations 5905(2),(4), and (6)

Parallel regimes would be introduced with respect to subsection 93(1) deemed dividends arising in the context of share redemptions (governed by Regulation 5905(2)) and foreign mergers (governed by Regulations 5905(3) and (4)), and in the context of a disposition by a corporation resident in Canada to a related taxable Canadian corporation (governed by R. 5905(5)(a) and (6)).

With respect to adjustments required for a subsection 93(1) deemed dividend arising on a Regulation 5905(5)(a) transaction (i.e. a sale of shares of a foreign affiliate by a corporation resident in Canada to a non-arms length taxable Canadian corporation), a different approach is proposed in Regulation 5905(6)(a). In particular, the reduction to the exempt and/or taxable surplus of each relevant foreign affiliate to reflect the exempt and/or taxable surplus portion(s) of the subsection 93(1) deemed dividend is not referenced to "exempt surplus reduction" or "taxable surplus reduction" amounts, but rather these reduction amounts are set out in regulation 5905(6)(a). Each of these amounts is computed in a manner similar to the exempt surplus and taxable surplus a reduction amounts.

There also appears to be a deficiency in Regulation 5905(6)(a) with respect to the allocation of relevant affiliates' exempt/taxable deficits. With respect to the allocation of exempt deficits, for example, rather than having both an "exempt deficit reduction" amount and a "taxable deficit allocation" amount, Regulation 5905(6)(a) provides for a "taxable deficit allocation" amount, but also provides for what would otherwise be the "exempt deficit reduction" amount only in a situation where the issuing foreign affiliate has a net consolidated exempt deficit amount.[27]

Example D



	Before	After
ACB	0	250
FMV	250	250
ES	300	86 [-214]
TS	0	0
UFT	0	0
ED	0	0
TD	0	0

ACB	300	250
FMV	250	250
ES	0	0
TS	0	0
UFT	0	0
ED	(100)	0
TD	0	0

ACB	100	150
FMV	150	150
ES	100*	29 [-71]
TS	0	0
UFT	0	0
ED	0	0
TD	0	0

* 100 x 50% = 50

Assumptions:

- Canco sells FA1 to Cansub for cash of $250, and makes a subsection 93(1) election for $250 ($2.50 per share) (all deemed to be an ES dividend).

In Example D, FA1 would be deemed to have consolidated exempt surplus of $350, consolidated exempt deficit of $100, and consolidated net surplus of $250. Under proposed Regulation 5905(6)(a)(i)(A), the ES of both FA1 and FA3 would be reduced proportionately to reflect the ES portion ($250) of the subsection 93(1) elected amount. This reduction for FA1 would be $214 (being 300/350 x 250/100%) and for FA3 would be $71 (being 100/350 x 250/.5). Since

[27] In such a situation, the grind to a particular affiliate's ES is the ES amount.

FA1's consolidated exempt deficit is less than its consolidated exempt surplus, there is no amount determined under proposed Regulation 5905(6)(a)(i)(C). There is also no amount determined under proposed Regulation 5905(6)(a)(i)(D) and Regulation 5905(19), since there is no consolidated taxable deficit. Under proposed Regulation 5905(6)(a)(iv), the ED of FA2 would be reduced to *nil*.

After the Regulation 5905(6)(a) adjustments, the ES of FA1 would be reduced to $86, the ED of FA2 would be reduced to *nil*, and the ES of FA3 would be reduced to $29. Since Canco made a subsection 93(1) election equal to the consolidated net surplus ($250), there should be no ES left in the group. We would expect that Regulation 5905(6)(a)(i)(C) should be modified so that the amount determined in Regulation 5905(6)(a)(i)(C) will be the "exempt deficit reduction" amount as determined under Regulation 5905(17).

Our comments above with respect to the complexity and the compliance burden imposed on taxpayers are relevant here as well.

Basis Adjustments – Proposed Subsections 92(1.1) to (1.4)

In recognition of the fact that decreasing an affiliate's surplus would result in an erosion of the ACB of its shares on a subsequent distribution of the value reflected by that surplus, and in recognition of the fact that deficit duplication could arise as a result of upward deficit attribution because of an inherent loss in the relevant shares, proposed subsections 92(1.1) to (1.4) would introduce a regime that would adjust the ACB of the shares of a particular relevant foreign affiliate (other than the disposed affiliate) to reflect adjustments to its accounts arising because of a subsection 93(1) election. However, these adjustments would only apply (i) to some extent, (ii) only for certain purposes, and (iii) only in respect of shares that are excluded property at the relevant times.

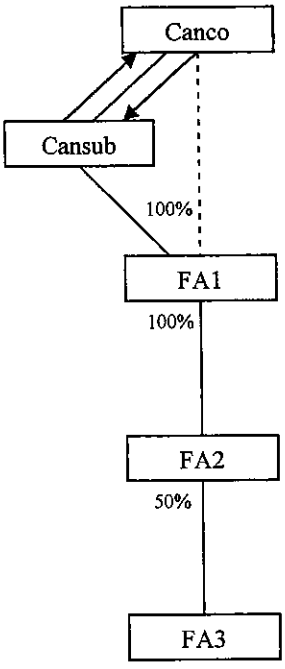
Pursuant to proposed Regulation 5911(1), the amount of the relevant increase to ACB would be the lesser of two amounts. The first would be the amount, if any, by which the FMV of the relevant shares (at the election time) exceeds their ACB. The second amount would be the amount generally determined under Regulation 5911(1)(b), which is the amount (on a per share basis) that the particular affiliate's consolidated net surplus would have been reduced by the Regulation 5905 adjustments if the particular affiliate had been the disposed affiliate.

Similarly, proposed Regulation 5911(2) would prescribe the amount by which the ACB of the shares of a particular relevant foreign affiliate would be reduced to account for the attribution of its deficits. Again, however, this adjustment is the lesser of two amounts. The first is the amount, if any, by which the ACB of the relevant shares exceeds their FMV. The second

amount, determined under Regulation 5911(2)(b), would be the amount (on a per share basis) of the particular affiliate's consolidated net deficit.[28]

In addition, where the relevant share does not have any attributable "consolidated net surplus" or "consolidated net deficit", and therefore no adjustment would be made under proposed Regulation 5911(1) or (2), it appears to be intended that there be an adjustment pursuant to proposed Regulation 5911(3), increasing the ACB of the relevant share by the lesser of any difference between its FMV and its ACB and the amount of any "consolidated net surplus" remaining in the relevant affiliate after the first order adjustments are made as a result of the subsection 93(1) election. The effect and implications of this provision are not clear.

Example E (same as Example D)



	Before	After
ACB	0	250
FMV	250	250
ES	300	86 [-214]
TS	0	0
UFT	0	0
ED	0	0
TD	0	0

ACB	300	250
FMV	250	250
ES	0	0
TS	0	0
UFT	0	0
ED	(100)	0
TD	0	0

ACB	100	150
FMV	150	150
ES	100*	29 [-71]
TS	0	0
UFT	0	0
ED	0	0
TD	0	0

* 100 x 50% = 50

Assumptions:

- Canco sells FA1 to Cansub for cash of $250, and makes a subsection 93(1) election for $250 ($2.50 per share) (all deemed to be an ES dividend).

[28] This is not actually an expression defined or used in the proposed amendments, but has been adopted by the authors to refer to the amount by which the total of the relevant affiliate's "consolidated exempt deficit" and its "consolidated taxable deficit" exceeds the total of its "consolidated exempt surplus" and its "consolidated taxable surplus".

Proposed Regulation 5911(1) would prescribe $0.50 as the amount the ACB of each share of FA3 should be increased under paragraph 92(1.3)(a) (for certain purposes), being the lesser of two amounts, namely

(a) the amount of which the FMV of the share exceeds its ACB ($0.50); and
(b) the amount(s) by which the consolidated net surplus would have been reduced under Regulation 5905 had the FA3 share been the disposed share (i.e., $0.71, being A/C x (C – B) = 1.00/100 x (100 – 29)).[29]

With respect to each share of FA2, the amount determined under Regulation 5911(2)(b) would be *nil*, being A/C x (C – B), where A = 0, B = 0 and C = 100. It would appear that the amount under Regulation 5911(1)(b) would also be *nil*, being A/C x (C – B) = 0/0 x (0 – 0).

However, Regulation 5911(3)(b) would not appear to have application for FA2, since the amount determined in both 5911(1)(b) and 5911(2)(b) for FA2 is *nil*, and the amount determined for B in the formula in 5911(1)(b), and for C in the formula in 5911(2)(b), is also *nil*. In any event, the amount determined under Regulation 5911(3) for FA2 would, in this Example, be *nil*, since the FMV of the FA2 shares does not exceed their ACB.

Joint Committee's Comments

The Committee agrees that, conceptually, if the surplus or deficit of an affiliate is adjusted in accordance with the proposed changes to Regulation 5905 discussed above as a result of a 93(1) election, it is appropriate and necessary to adjust the ACB of the shares of the affiliate. However, the purpose, effect and other implications of these provisions are unclear in various respects. The Committee submits that this is, once again, the result of the exceedingly complex nature of the Department's proposals requiring the computation consolidated net surplus and adjusting surplus/deficit balances as a result of a 93(1) election. For example, it is not clear why the "purposes" mentioned in proposed subsection 92(1.4) would not make any reference to the computation of FAPI. The Committee submits these basis adjustments should be made for all purposes of the foreign affiliate rules in the Act and the Regulations, and whether the relevant shares are excluded property, to minimize inordinate tax attribute erosion or deficit duplication.

In addition, it is not clear why the adjustment to ACB of the relevant share, pursuant to Regulation 5911, is restricted in paragraph 92(1.3)(a) to the excess of FMV over ACB and in paragraph 92(1.3)(b) to the excess of ACB over FMV, and not the full amount of the adjustment to the affiliate's surplus/deficit, as the case may be. These provisions seem to assume that the FMV of the shares of a FA will be less than ACB if the FA has a deficit and that the FMV of the shares will be greater than ACB if it has a surplus balance. This is not necessarily the case.

[29] The Committee submits that the reference in Description B in 5911(1)(b) should be to 5902(1)(e)(vi).

Surplus/deficits could be positively/adversely affected by various timing differences and unrealized gains and losses.

More importantly, the logic reflected in this particular proposal demonstrates that the logic reflected in the proposed corresponding amendments to Regulation 5905 is backwards, in that the amount of the adjustment to the affiliates surplus/deficit should be limited in the first place to the excess of FMV over ACB (in the case of a deficit push-down), and to the excess of ACB over FMV (in the case of a deficit pull-up).[30] As noted above, deficit should never be attributed upwards in an amount exceeding the shareholder's economic loss on the shares. If upward deficit attribution was limited in this manner, then it would make sense and it would be consistent to limit basis adjustments in the same manner – to the difference between ACB and FMV – but such a limitation to basis adjustments is not appropriate if there is no corresponding limitation to surplus and deficit adjustments.

Finally, we would emphasize that the substitution of ACB adjustments for surplus or deficit attributes would not necessarily be appropriate, and would reflect yet another departure from the existing architecture of the system. That is, surplus and deficit attributes are accounted for in the relevant affiliate's calculating currency, but the ACB of its shares would be calculated either in Canadian Dollars or in the shareholder's calculating currency. Thus, if we assume that a particular affiliate has ES of $100 US Dollars, and the ACB of its shares is *nil*, and then its ES is reduced to *nil* and the ACB of its shares is increased by $100 US Dollars – or, rather, by the Canadian Dollar or other calculating currency equivalent of $100 US Dollars at that time – then the amount of value that could subsequently be extracted from that affiliate without any gain or loss at the shareholder level would be the Canadian Dollar or other calculating currency equivalent of $100 US Dollars at that time – that is, the adjustment time, not the subsequent distribution time. Accordingly, if the value of the affiliate's calculating currency (the US Dollar, in our example) increases relative to the Canadian Dollar or its shareholder's calculating currency, then there would be a gain upon the extraction of the original surplus (i.e., the $100 US Dollars). Conversely, if the value of the affiliate's calculating currency (the US Dollar) decreases relative to the Canadian Dollar or its shareholder's calculating currency, then there would be a loss upon the extraction of the original surplus (i.e., the $100 US Dollars). Neither result is appropriate, which explains why the current architecture of the system is configured as it is, and why it should not be reconfigured.

Summary: Joint Committee's Comments on Surplus Adjustments and 93(1) Elections

The Committee respectfully submits that even if it is assumed that the proposed changes with respect to surplus adjustments and subsection 93(1) would improve the current system (and, based on the technical and structural deficiencies noted above, this is far from being the case), it

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[30] See Joint Committee's Comments above under *Amount of Election – Proposed Regulation 5902(1)*

must be acknowledged that the price would be a significant increase in the complexity of the foreign affiliate system and in the compliance burden on taxpayers to maintain accurate and up-to-date surplus balances and ACB balances and to make adjustments thereto. In addition, it must be acknowledged that many of the proposed changes go to the very foundation of the system's architecture, and would in many cases give rise to results that are inappropriate.

The surplus balances of any foreign affiliate are difficult to know with any degree certainty at any particular moment in time. Therefore, a transaction that requires knowledge of the surplus balances at the time the transaction is carried out will create greater uncertainty. Even if the relevant foreign tax returns are complete and the surplus balances are computed on the basis of those returns, they are still subject to change as a result of regular day-to-day surplus maintenance. For example, final foreign audit adjustments may only be made years after the taxation year(s) in question ended. Furthermore, surplus balances are open for audit by CRA for all years back to 1972. These issues make it very difficult for a taxpayer to be compliant even before attempting to assess the ability to comply with the 93(1) proposals.

The proposals elevate the importance of the surplus balances of each affiliate, by

- making more affiliates relevant under the consolidated net surplus approach for the purposes of a subsection 93(1) election,
- requiring adjustments to the surplus or deficit balances of each of those affiliates, and
- making the ACB adjustments dependent upon the surplus balances.

However, as indicated above, for various reasons these surplus balances are continually subject to change. By increasing the timely importance of an amount (i.e., a surplus balance), which is already uncertain, the proposals create a system where taxpayers will have to make tax-related decisions despite the inability to know the Canadian income tax results of a particular transaction. In effect, taxpayers are being forced to know the exact surplus balances of their various affiliates regardless of the inherent limitations that prevent such perfect surplus knowledge. As a result, the Committee firmly believes that it will be virtually impossible for many taxpayers to be compliant, not because of unwillingness on their part, but rather because of the inability to cope with (i) the real time certainty of the surplus/deficit balances and ACB calculations that these proposals inherently demand and (ii) the complexity inherent in the relevant provisions that require adjustments to the surplus/deficit balances and the ACB calculations.

In summary, while the Committee acknowledges the Department's concerns with possible abuses under the current 93(1) rules, the proposed approaches contain various technical and structural deficiencies that do not enhance – and, in many cases, compromise – the integrity of the foreign affiliate system. Further, the deficiencies in the current system do not warrant the level of complexity and compliance burden that these proposals would impose. The Committee

strongly recommends that this proposal to net surplus and deficit accounts at different tiers (and in different currencies) and to substitute ACB adjustments for those attributes should be withdrawn. At a minimum, it is our recommendation that any change to the rules for determining the amount or consequences of a 93(1) election should not result in a burden for taxpayers that will make it nearly impossible for most to understand, let alone comply with the rules. Furthermore, any such changes should not create a bias in favour of paying actual dividends, and a corresponding incentive to incur foreign withholding tax, and should not result in deficit over-attribution, or inadequate ACB adjustments giving rise to potential deficit duplication.

Proposed Regulation 5905(7)

Under current rules, a liquidation of a foreign affiliate results in the elimination of any deficit which it may have had, since the liquidating affiliate is merely deemed to pay a dividend equal to its adjusted net surplus for these purposes. However, proposed Regulations 5905(7) to (7.4) would introduce a regime that would provide for continuity in respect of deficits (and surplus) where a particular affiliate is liquidated into another affiliate.

Surplus Continuity

Once again, a distinction would be drawn between the circumstances in which proposed paragraph 95(2)(e) applies, and those in which proposed paragraph 95(2)(e.1) applies. Where proposed paragraph 95(2)(e.1) applies, each affiliate of the relevant corporation that had a direct equity percentage in the liquidating affiliate would be deemed, pursuant to proposed Regulation 5905(7)(a), to have received dividends from the liquidating affiliate equal to its proportionate share of the liquidating affiliate's net surplus. However, where proposed paragraph 95(2)(e) applies, there would be no such automatic surplus continuity.

Deficits

Surprisingly, deficit continuity would be provided for even if proposed paragraph 95(2)(e) would apply to the liquidation.[31] Pursuant to proposed Regulation 5905(7)(d), the ES of each higher-tier affiliate would be deemed to be decreased by its proportionate share of any ED of the liquidating affiliate and, to the extent that such proportionate share of ED exceeds that ES, the balance would serve to increase the higher-tier affiliate's ED in accordance with proposed Regulation 5905(7)(b). Similarly, pursuant to proposed Regulation 5905(7)(e), the TS of each higher-tier affiliate would be deemed to be decreased by its proportionate share of any TD of the liquidating affiliate and, to the extent that such proportionate share of TD exceeds that TS, the

[31] Very surprisingly, the application date for the deficit continuity in a paragraph 95(2)(e) liquidation and dissolution is dissolutions that occur after December 22, 2002 even though there was no mention in the December 22, 2002 proposals that this amendment would apply in a paragraph 95(2)(e) context.

balance would serve to increase the higher-tier affiliate's TD in accordance with proposed Regulation 5905(7)(c).[32]

These rules could result in effective deficit duplication where the shareholder affiliate realizes a loss as a result of the disposition, and is required to pick up a portion of the liquidating affiliate's deficit, where the loss and the deficit reflect the same underlying economic loss. The liquidation would not result in a loss on the shares of the liquidating affiliate if proposed paragraph 95(2)(e.1) were applicable. However, if proposed paragraph 95(2)(e) were applicable, a loss could result from the disposition of the shares of the liquidating affiliate. If, in addition, the higher-tier affiliate is required to pick up its share of the liquidating affiliate's deficit, then duplication will arise. Moreover, in either context, it would appear that duplication could arise where the higher-tier affiliate has capitalized the liquidating affiliate with debt rather than equity, to the extent that a loss from the disposition of the debt is realized by the higher-tier affiliate and that debt has financed the underlying deficit.

In brief, while the Committee acknowledges (as noted above) that there should be some mechanism to preserve deficits on the liquidation of an affiliate, we would strongly recommend that any changes in this regard be made in a manner that does not result in deficit over-attribution or deficit duplication, with a view to the economic realities of the particular liquidation.

Inter-Affiliate Financing

On a final note, before concluding, we would draw your attention to certain issues that arise under the Regulations in the inter-affiliate financing context. In particular, we refer to the Regulations that correspond to the provisions in paragraph 95(2)(a) of the Act. These would be set out, *inter alia*, in proposed subparagraph (d)(ii) of the definition of "exempt earnings" and proposed subparagraph (c)(ii) of the definition of "exempt loss" in Regulation 5907(1) (hereafter, the "95(2)(a) Regulations".

In principle, the additional conditions for the application of the 95(2)(a) Regulations (over and above the conditions in the corresponding provisions in paragraph 95(2)(a) of the Act) should be designed to distinguish between treaty-country and non-treaty-country income flows and assets, but not otherwise. Thus, for the purposes of the modified paragraph (c) of the definition of "excluded property" applicable in the context of clause (H) of the 95(2)(a) Regulations, all assets that give rise to exempt earnings to their recipients, or would give rise to

[32] What is not clear is why the rules in proposed Regulations 5905(7)(b) and (c) would increase the higher-tier affiliate's ED or TD, as the case may be, by the "total of" its proportionate share of the liquidating affiliate's ED or TD and the amount, if any, by which this amount exceeds any reduction to its ES or TS under proposed Regulations 5905(7)(d) and (e). Arguably, to the extent that a higher-tier affiliate's proportionate share of a liquidating affiliate's deficits are applied to reduce its ES or TS under proposed Regulations 5905(7)(d) and (e), then that part of such proportionate share of the liquidating affiliate's deficits should not be applied again to increase its ED or TD under proposed Regulations 5905(7)(b) and (c). To do so would seem to be duplicative. Thus, it would seem that these references to the "total of" should be replaced with references to the "lesser of".

such exempt earnings if there were income from those assets or if those assets were disposed of, should qualify as "excluded property".[33] A similar rule should also be put in with respect to excluded property described in proposed paragraphs (a) and (c.1) of that definition in subsection 95(1). With respect to excluded property described in paragraph (b) of that definition in subsection 95(1), we would suggest the reintroduction of a rule such as that in subclause (H)(IV) of the current 95(2)(a) Regulations, with certain refinements, such that it would read as follows:

> "(IV) the shares of a foreign affiliate (in this subclause referred to as the "non-qualifying affiliate") of the taxpayer that is not resident and subject to income taxation in a designated treaty country are not considered relevant for the purpose of determining whether shares of another foreign affiliate (in this subclause referred to as the "tested affiliate") of the taxpayer are excluded property unless the shares of the tested affiliate would not have been excluded property if the shares of all such non-qualifying affiliates were not excluded property and the tested affiliate had no property that did not constitute excluded property for the purposes of this clause other than the shares of all such non-qualifying affiliates owned by the tested affiliate,"[34]

Moreover, this issue also arises in connection with other clauses in the proposed 95(2)(a) Regulations. In particular, we refer to clauses (L) and (M) of the proposed 95(2)(a) Regulations. Neither of these would seem to include items owing by partnerships, or items such as trade accounts receivable or certain loans and lending assets that generate exempt earnings.

Conclusions

As noted throughout this Submission, we have significant continuing concerns with respect to certain aspects of the proposed amendments to the foreign affiliate rules. While many of the proposed amendments are technical and relieving in nature, others seem to introduce restrictive – and, in some cases, unduly burdensome – departures from current rules and underlying principles. Moreover, in our view, while many of the proposed amendments would

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[33] As currently drafted, the language in subclause (H)(III) of the proposed 95(2)(a) Regulations would seem to exclude (or in any event does not sufficiently clearly include) amounts receivable from related non-resident corporations or partnerships because the latter are not actually entitled to deduct payments thereunder in computing their exempt earnings, because they have no exempt earnings as such, and would not seem to cover trade accounts receivable, or loans and lending assets, where the debtor is a third party, since the third party similarly has no relevant exempt earnings. Similarly, and somewhat ironically, this language would seem to exclude a receivable that generates exempt earnings because of clause 95(2)(a)(ii)(D), because the interest expense on such a receivable may be deducted in computing exempt surplus, but not in computing exempt earnings. These assets should qualify as long as they do or would give rise to exempt earnings to the recipient.

[34] However, we would recommend that the reintroduction of this requirement be made prospectively only, in that there may be taxpayers who have relied on its absence in the period between December 20, 2002, and the release of the next version of proposed amendments.

seem to be refined enough at this point to merit proceeding forward to the Technical Bill stage, certain of the proposals, as currently structured or drafted, would in many cases appear to be ineffective, overly disruptive of the scheme of the Act and Regulations in this area, and/or fiscally punitive. In particular, we note the following principal areas of concern:

- The proposed amendments with respect to "internal dispositions" would operate on the basis of a "suspended income and gains" mechanism, the introduction of which would in our view result in numerous anomalies in the distribution of economic values and tax attributes within a chain of foreign affiliates. In addition, we are aware of examples where this approach could result in the punitive taxation as FAPI of gains which accrued on excluded property, as well as in the complete ineffectiveness of the proposed amendments. These anomalies would in our view arise because of structural aspects of the approach being adopted, rather than because of drafting issues.

- The proposed amendments with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates would also appear to give rise to anomalous consequences in many cases, as a result of certain structural aspects of their formulation. In this context, we have seen examples of transactions that would result in the imposition of taxation under the Act in circumstances involving no more than a simple corporate combination or other reorganization that does not in any substantive way alter the indirect economic relationship between the relevant assets or surplus and the relevant taxpayer(s), as well as examples where radically different consequences would arise under the Act or the Regulations depending on whether a merger rather than a liquidation or other reorganization transaction is implemented even though the exact same corporate and commercial result would be achieved either way.

- The proposed amendments with respect to subsection 93(1) elections and adjustments to be made to the various surplus and other accounts of a foreign affiliate as a result of the application of the subsection 93(1) deemed dividend rules, and in the context of certain changes to a relevant taxpayer's surplus entitlement percentage, would also appear to result in anomalous consequences in certain cases, including the over-attribution of underlying deficits and, more generally, the "scrambling" of surplus accounts. In addition, these measures would appear to introduce inordinate uncertainty, complexity and administrative and compliance costs into the system.

We believe that alternative approach could be devised for "internal dispositions" that could address the concerns of Finance in this regard in a manner that would not give rise to such anomalies. Similarly, we believe that the concerns of Finance with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates could be addressed in a more conceptually coherent manner, and more consistently with certain of the fundamental principles that underlie the scheme of the Act and Regulations in this area. We also believe that Finance's concerns with respect to the surplus account adjustment rules could be

addressed in a more efficient manner, that would not disrupt the relationship between tax attributes and economic values, and therefore would be more consistent with the underlying purpose of these rules. We would be pleased to discus with you our thoughts in this regard at your convenience.