Subject/Sujet:	Distributions of Property of a Foreign Affiliate
Date/Date:	August 19, 2004
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [proposed]/LIR 88(3) [proposé]

Dear xxxxx,

We are responding to your correspondence and related communications made on behalf of xxxxxxx in connection with proposed subsection 88(3) of the *Income Tax Act* (the "Act"), as contained in the draft technical amendments released on February 27, 2004 by the Minister of Finance, the Honourable Ralph Goodale.

In your correspondence and communications, you mention the case where a foreign affiliate of a taxpayer resident in Canada makes a payment to the taxpayer of an amount in respect of shares held by the taxpayer of a particular class of shares of the capital stock of the foreign affiliate. For the purposes of your submission, you ask us to assume that

- the payment in question is not a dividend under the relevant foreign corporation law governing the foreign affiliate and is a reduction or a return to the taxpayer of the shares' portion of the paid-up capital in respect of the particular class of shares under that law, and

- the amount of the payment in question does not exceed the taxpayer's pro-rata portion (based on the proportion that the number of shares of the particular class of shares held by the taxpayer is of the total number of outstanding shares of the particular class) of the amount of money that had been received by the foreign affiliate on the issuance of shares of the particular class or received by another foreign affiliate of the taxpayer on the issuance of shares of the capital stock of that other foreign affiliate that were exchanged for shares of the particular class.

Under the Act as it currently reads, the payment in question would be treated as a return of the paid-up capital of the shares of the particular class held by the taxpayer and would be deducted, under paragraph 53(2)(b), in computing the adjusted cost base to the taxpayer of the shares. No amount would, under the Act as it currently reads, be included in the income of the taxpayer in respect of the payment except amounts that may be required to be included in the taxpayer's income because of a gain that could arise, under subsection 40(3), in respect of the payment if the amount of the payment exceeded the taxpayer's adjusted cost base of those shares held by the taxpayer.

The proposed subsection 88(3) of the Act that was included in the February 27, 2004 draft technical amendments was not intended to change the tax outcome described above in respect of the payment made as a return of the paid-up capital of the shares of the foreign affiliate described above. Although our Branch is studying further revisions to that proposed subsection 88(3), it is not intended that any such revisions that we would recommend to the Minister of Finance would change that tax outcome in respect of such a payment. I can also confirm that the operation of that proposed subsection 88(3) is not intended to be dependent upon the source of the funds used by the foreign affiliate of the taxpayer to make such a payment to the taxpayer.

I trust that the foregoing provides the clarifications sought.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation
Division Tax Policy Branch

Subject/Sujet:	Distributions of Property of a Foreign Affiliate
Date/Date:	January 19, 2005
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed]/LIR 88(3) [Proposé]

Dear xxxxx,

Thank you for your letter dated July 30, 2004 in connection with proposed subsection 88(3) of the *Income Tax Act* (the "Act"), as contained in the draft technical amendments released on February 27, 2004 by the Minister of Finance.

Your letter relates to the application of that proposed subsection 88(3) to a proposed distribution of money to a taxpayer resident in Canada by a foreign affiliate of the taxpayer made in respect of shares of the capital stock of the foreign affiliate held by the taxpayer. According to your letter, that distribution is in respect of amounts included in the shares' portion of the paid-up capital (determined under the relevant foreign corporation law) in respect of the class of shares of the capital stock of the foreign affiliate to which the shares belong.

Your concern is that the portion of a distribution that is not treated by proposed subsection 88(3) as a reduction to the adjusted cost base to the taxpayer of the shares would be treated by that proposed subsection as income from property (other than dividends) from the shares. You request that that proposed subsection 88(3) be revised so as to treat the amount of that distribution made to the taxpayer in respect of the shares, to the extent that the amount exceeds the total of the amounts of the reductions in respect of the distribution to the adjusted cost base to the taxpayer of the shares, as the payment of a dividend on the shares. You argue that such a revision to proposed subsection 88(3) would, where the taxpayer is a corporation, enable the taxpayer to benefit from the deductions permitted under section 113 of the Act in respect of dividends paid by the foreign affiliate that are prescribed by the Income Tax Regulations to be paid out of the foreign affiliate's exempt surplus in respect of the taxpayer.

From a tax policy perspective, we agree that, in the circumstances described in your letter, it would be appropriate to make the change you have requested. We are currently considering revisions to that proposed subsection 88(3) of the Act, and the requested revision to subsection 88(3) that is described in this letter is to be included in our recommendations to the Minister of Finance.

Thank you again for writing.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch

Subject/Sujet:	Distribution of Property of a Foreign Affiliate When Liquidation or Dissolution
Date/Date:	August 16, 2005
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed]/LIR 88(3) [Proposé]

Dear xxxxx,

I am writing in response to your letter dated July 11, 2005 with respect to proposed subsection 88(3) of the *Income Tax Act* as contained in the foreign affiliate proposals announced on February 27, 2004 by the Minister of Finance. You requested confirmation of certain possible modifications to that proposed subsection 88(3) and, presumably, certain other modifications to section 88 of the Act that would apply in the case of certain liquidations and dissolutions of foreign affiliates of a taxpayer resident in Canada.

As noted in your letter, existing subsection 88(3) of the Act provides that, where a property of a controlled foreign affiliate of a taxpayer resident in Canada that is a share (the "disposed share") of the capital stock of another foreign affiliate of the taxpayer is disposed of to the taxpayer on the dissolution of the controlled foreign affiliate (the "dissolved foreign affiliate"), the dissolved foreign affiliate's proceeds of disposition of the disposed share are deemed to equal its adjusted cost base to the dissolved foreign affiliate immediately before the dissolution (or such greater amount as the taxpayer claims not exceeding the fair market value of the disposed share). The taxpayer's cost of the disposed share is deemed to equal the disposed foreign affiliate's proceeds of disposition in respect of the disposed share. In accordance with the results determined under section 69 of the Act, each other type of property of the dissolved foreign affiliate that is disposed of by the dissolved foreign affiliate to the taxpayer on the dissolution is treated as having been disposed of by the dissolved foreign affiliate for proceeds, and to have been acquired by the taxpayer at a cost, equal to that property's fair market value. The taxpayer's proceeds from the disposition of the shares of the capital stock of the dissolved foreign affiliate are deemed to equal the amount (if any) by which the total cost to the taxpayer of all the property disposed of to the taxpayer by the dissolved foreign affiliate on the dissolution exceeds the total amount of debts and other obligations of the dissolved foreign affiliate (other than dividends payable to the taxpayer or nonarm's length persons) that are assumed or cancelled by the taxpayer on the dissolution.

As you know, proposed subsection 88(3), as contained in the February 2004 proposals, substantially changed the scope and operation of the rule. In particular, the scope of the rule was extended to cover all distributions of property by all foreign affiliates of the taxpayer to the taxpayer, whether or not the distribution was on the dissolution of the foreign affiliate or the foreign affiliate was a controlled foreign affiliate of the taxpayer. For example, a distribution of a property by a foreign affiliate of a taxpayer (the "distributing foreign affiliate") to the taxpayer as a dividend in kind receives the same treatment as the distribution of that property to the taxpayer on a share redemption made by the distributing foreign affiliate or in the course of a liquidation and dissolution of the distributing foreign affiliate. As well, in contrast to existing subsection 88(3), shares of the capital stock of another foreign affiliate of the taxpayer that are distributed by the distributing foreign affiliate to the taxpayer would be treated differently under the February 2004 proposals, depending on whether or not the shares are excluded property of the foreign affiliate. Where such a distributed share is an excluded property of the foreign affiliate, under the February 2004 proposals, the taxpayer is permitted to elect to treat the distributing foreign affiliate's proceeds of disposition of the share as being an amount that is equal to the adjusted cost base, immediately before the distribution, of the share or such greater amount that does not exceed the fair market value of the share immediately before the distribution. Where it is not, the share is treated, in accordance with the results that would be obtained under section 69, as having been disposed of by the distributing foreign affiliate for proceeds of disposition equal to the fair market value of the share immediately before the distribution.

In your letter, you refer to comments made by Department of Finance officials that the Tax Legislation Division is considering requested revisions to proposed subsection 88(3) that would provide an additional and distinct rule in circumstances where a distributing foreign affiliate of a taxpayer, that is wholly-owned or substantially wholly-owned by

the taxpayer, distributes, in the course of its liquidation and dissolution, property to the taxpayer in respect of shares of the capital stock of the distributing foreign affiliate held by the taxpayer. Under such revisions, the taxpayer would be able to elect the distributing foreign affiliate's proceeds of distribution and the taxpayer's cost for each property of the distributing foreign affiliate (not only excluded property) that is distributed by it to the taxpayer in such circumstances. The revisions would provide that the taxpayer could elect an amount that would result in no gain or loss of the distributing foreign affiliate in respect of the distributed property, or such greater amount (not exceeding the distributed property's fair market value) that would result in a gain of the distributing foreign affiliate in respect of the distributed property. You request confirmation that such revisions will be recommended to the Minister of Finance.

From a tax policy viewpoint, we would support such an additional and distinct rule in subsection 88(3) provided that the distributing foreign affiliate is wholly-owned or substantially wholly-owned by the taxpayer. In those circumstances, it could be considered that no substantial change in the ultimate economic interests in the distributed property of the distributing foreign affiliate could occur by reason of the liquidation and dissolution of the distributing foreign affiliate. We note that subsection 88(1) requires ownership of not less than 90 percent of shares of each class and, all things being equal, we would propose to apply the same threshold in the context of subsection 88(3). Based, however, on discussions with representatives of the tax community on this point, we are prepared to adopt a different test in connection with subsection 88(3) to determine whether the taxpayer meets the equity ownership threshold in the foreign affiliate to qualify for such an additional and distinct rule in that subsection. The test would require the taxpayer to hold shares of the capital stock of the foreign affiliate such that, in total, the taxpayer has at least 90 percent of the voting rights at a general meeting of the foreign affiliate in all circumstances (immediately before the commencement of the liquidation and dissolution of the foreign affiliate) and such that the fair market value of all properties distributed to the taxpayer, in respect of shares of the capital stock of the foreign affiliate, by the foreign affiliate in the course of the liquidation and dissolution is equal to at least 90 percent of the total fair market value of all properties distributed to all shareholders of the foreign affiliate, in respect of shares of the capital stock of the *foreign* affiliate, by the foreign affiliate in the course of the liquidation and dissolution.

Although the technical details of the possible modifications to that proposed subsection 88(3) and to section 88 of the Act are still being finalized, we can confirm, in general terms, our intention to recommend that modifications be made to that proposal and to section 88 and other relevant provisions of the Act. Those recommended modifications would treat a liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada as a qualifying liquidation and dissolution of that foreign affiliate of the taxpayer if the taxpayer meets the required equity ownership threshold in the foreign affiliate. In general terms, the recommended modifications would also provide for the following tax rules in respect of a qualifying liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada where the taxpayer so elects in writing to have those tax rules apply in respect of the qualifying liquidation and dissolution of the foreign affiliate:

- the foreign affiliate would be deemed to have disposed of each property (the "distributed property") that is distributed, in the course of the qualifying liquidation and dissolution, by the foreign affiliate to the taxpayer in respect of shares of the capital stock of the foreign affiliate held by the taxpayer for proceeds of disposition (assuming that the foreign affiliate has not received consideration from the taxpayer in respect of the distributed property that exceeds the amount described below as the "relevant cost amount" of the distributed property) that are equal to the greater of
    - the "relevant cost amount" of the distributed property to the foreign affiliate in respect of the taxpayer (being essentially the amount that would generally result in no gain or loss to the foreign affiliate in respect of the taxpayer in respect of the disposition of the distributed property), and
    - the amount elected by that taxpayer (not exceeding the fair market value of the particular distributed property);
- any income or taxable capital gain of the foreign affiliate derived from the disposition of the distributed property would be included in computing the foreign affiliate's foreign accrual property income in respect of the taxpayer;
- the taxpayer's cost of the distributed property would be deemed to be equal to the foreign affiliate's proceeds of disposition of that property;
- the amount of the distribution made by the foreign affiliate to the taxpayer in respect of the distributed property would be deemed to be equal to the amount, if any, by which the cost to the taxpayer of the distributed property exceeds the total of all of the following amounts:
    - the portion of an amount owing by or of an obligation of the foreign affiliate (other than dividends payable to the taxpayer or non-arm's length persons) that was assumed or cancelled by the taxpayer

because of that distribution of the distributed property, and

- the cost to the foreign affiliate of a property that was received by the foreign affiliate from the taxpayer as consideration for that distribution by the foreign affiliate of the distributed property; and

- the portion of the amount of the distribution made by the foreign affiliate to the taxpayer in respect of the distributed property that relates to a particular share of the capital stock of the foreign affiliate would be treated as

  - a return of the paid-up capital in respect of the particular share in respect of the taxpayer to the extent of the "foreign paid-up capital" in respect of the particular share in respect of the taxpayer (generally, the particular share's portion of the total amounts contributed by the foreign affiliate's shareholders to the foreign affiliate in respect of the shares of the class to which the particular share belongs, provided that those shareholder contributions were in respect of shares issued to or held by those shareholders), and

  - a dividend paid by the foreign affiliate to the taxpayer resident in Canada in respect of the particular share to the extent that that portion of the amount of the distribution is not treated as a return of the paid up capital in respect of the particular share in respect of the taxpayer.

We would recommend that such revisions to proposed subsection 88(3) of the Act and to section 88 and other relevant provisions of the Act apply to a liquidation and a dissolution, of a foreign affiliate of a taxpayer resident in Canada, that begins after February 27, 2004.

Thank you for writing.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch

Subject/Sujet:	Liquidation and Dissolution of Foreign Affiliate
Date/Date:	April 12, 2006
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed], 95(2)(e.1) [Proposed] / LIR 88(3) [Proposé], 95(2)e.1) [Proposé]

Dear xxxxx,

I am writing in response to your letters dated December 12, 2005 and January 30, 2006 with respect to proposed subsection 88(3) and paragraph 95(2)(e.1) of the *Income Tax Act* (the "Act") as contained in the foreign affiliate proposals announced on February 27, 2004 by the Minister of Finance. You have requested confirmation of certain possible modifications to proposed subsection 88(3) and paragraph 95(2)(e.1) and certain other identified related provisions of the Act that would apply to a liquidation and dissolution, after February 27, 2004, of a foreign affiliate of a taxpayer resident in Canada.

Subsection 88(3) of the Act

As noted in your correspondence, existing subsection 88(3) of the Act provides that, where a property of a controlled foreign affiliate of a taxpayer resident in Canada that is a share of the capital stock of another foreign affiliate of the taxpayer is disposed of to the taxpayer on the dissolution of the controlled foreign affiliate (the "disposing foreign affiliate"), the disposing foreign affiliate's proceeds of disposition of the share are deemed to equal its adjusted cost base to the disposing foreign affiliate immediately before the dissolution (or such greater amount as the taxpayer claims not exceeding the fair market value of the share). The taxpayer's cost of the share is deemed to equal the disposing foreign affiliate's proceeds of disposition in respect of the share. In accordance with the results determined under section 69 of the Act, each other type of property of the disposing foreign affiliate that is disposed of by the disposing foreign affiliate to the taxpayer on the dissolution is treated as having been disposed of by the disposing foreign affiliate for proceeds, and to have been acquired by the taxpayer at a cost, equal to that property's fair market value. Existing subsection 88(3) also provides that the taxpayer's proceeds from the disposition of shares held by the taxpayer in the capital stock of the disposing foreign affiliate are deemed to equal the amount (if any) by which the total cost to the taxpayer of all the property disposed of to the taxpayer by the disposing foreign affiliate on the dissolution exceeds the total amount of debts and other obligations of the disposing foreign affiliate (other than dividends payable to the taxpayer or non-arm's length persons) that are assumed or cancelled by the taxpayer on the dissolution.

In your correspondence, you asked for confirmation of our intention to recommend that proposed subsection 88(3) be revised to provide an additional and distinct rule in circumstances where a foreign affiliate (the "disposing foreign affiliate") of a taxpayer resident in Canada distributes, in the course of its liquidation and dissolution, property to the taxpayer in respect of shares of the capital stock of the disposing foreign affiliate held by the taxpayer. Under such a revision, the taxpayer would be able to elect to treat the amount of the disposing foreign affiliate's proceeds of distribution for each property of the disposing foreign affiliate (not only excluded property) that is distributed by it to the taxpayer in such circumstances as being such a particular amount that would result in no gain or loss of the disposing foreign affiliate in respect of the distributed property, or to be such an amount (not exceeding the distributed property's fair market value) that would result in a gain o the disposing foreign affiliate in respect of the distributed property. That particular amount would also be treated as the amount of the taxpayer's cost for that distributed property.

From a tax policy viewpoint, such an additional and distinct rule in subsection 88(3) would be supportable provided that the disposing foreign affiliate is wholly-owned or substantially wholly-owned by the taxpayer. It could, in those circumstances, be considered that no substantial change in the ultimate economic interests in the distributed property of the disposing foreign affiliate would occur by reason of the liquidation arid dissolution of the disposing foreign affiliate. We note that subsection 88(1) requires ownership of not less than 90% of the shares of each class and, all things being equal, we would propose to apply the same threshold in the context of subsection 88(3). Based, however,

on discussions with representatives of the tax community on this point, we are prepared to adopt a different test in connection with subsection 88(3) to determine whether the taxpayer meets the equity ownership threshold in the disposing foreign affiliate to qualify for such an additional and distinct rue in that subsection. The test would require the taxpayer to hold shares of the capital stock of the disposing foreign affiliate such that, in total, the taxpayer has at least 90% of the voting rights at a general meeting of the disposing foreign affiliate in all circumstances (immediately before the commencement of the liquidation and dissolution of the disposing foreign affiliate) and such that the fair market value of all properties distributed to the taxpayer, in respect of shares of the capital stock of the disposing foreign affiliate, by the disposing foreign affiliate in the course of the liquidation and dissolution is equal to at least 90% of the total fair market value of ail properties distributed to all shareholders of the disposing foreign affiliate, in respect of shares of the capital stock of the disposing foreign affiliate, by the disposing foreign affiliate in the course of the liquidation and dissolution.

Although the technical details of the possible modifications to that proposed subsection 88(3) and to the related provisions of the Act are still being finalized, we can confirm, in general terms, our intention to recommend that modifications be made to that proposal and to the other relevant provisions of the Act. Those recommended modifications would treat a liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada as a qualifying liquidation and dissolution of that foreign affiliate of the taxpayer if the taxpayer meets the required equity ownership threshold in the foreign affiliate. In general terms, the recommended modifications would also provide for the following tax rules in respect of a qualifying liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada where the taxpayer so elects in writing to have those tax rules apply in respect of the qualifying liquidation and dissolution of the foreign affiliate:

1. the foreign affiliate would be deemed to have disposed of each property (the "distributed property") that is distributed, in the course of the qualifying liquidation and dissolution, by the foreign affiliate to the taxpayer in respect of shares of the capital stock of the foreign affiliate held by the taxpayer for proceeds of disposition (assuming that the foreign affiliate has not received consideration from the taxpayer in respect of the distributed property that exceeds the amount described below as the "relevant cost amount" of the distributed property) that are equal to the greater of

- the "relevant cost amount" of the distributed property to the foreign affiliate in respect of the taxpayer (being essentially the amount that would generally result in no gain or loss to the foreign affiliate in respect of the taxpayer in respect of the disposition of the distributed property), and
- where the foreign affiliate is a controlled foreign affiliate of that taxpayer, the amount elected by that taxpayer (not exceeding the fair market value of the particular distributed property);

2. any income or taxable capital gain of the foreign affiliate derived from the disposition of the distributed property would be included in computing the foreign affiliate's foreign accrual property income in respect of the taxpayer;

3. the taxpayer's cost of the distributed property would be deemed to be equal to the foreign affiliate's proceeds of disposition of that property;

4. the amount of the distribution made by the foreign affiliate to the taxpayer in respect of the distributed property would be deemed to be equal to the amount, if any, by which the cost to the taxpayer of the distributed property exceeds the total of all of the following amounts;

- the portion of an amount owing by or of an obligation of the foreign affiliate (other than dividends payable to the taxpayer or non-arm's length persons) that was assumed or cancelled by the taxpayer because of that distribution of the distributed property, and
- the cost to the foreign affiliate of a property that was received by the foreign affiliate from the taxpayer as consideration for that distribution by the foreign affiliate of the distributed property;

5. the portion of the amount of the distribution made by the foreign affiliate to the taxpayer in respect of the distributed property that relates to a particular share of the capital stock of the foreign affiliate would not be treated as proceeds of disposition of the foreign affiliate of the distributed property and would be treated as

- a return of the paid-up capital in respect of the particular share in respect of the taxpayer to the extent of the "foreign paid-up capital" in respect of the particular share in respect of the taxpayer, and

- a dividend paid by the foreign affiliate to the taxpayer resident in Canada in respect of the particular share to the extent that that portion of the amount of the distribution is not treated as a return of the paid-up capital in respect of the particular share in respect of the taxpayer;

6. any loss of the taxpayer resident in Canada from the disposition of a particular share of the foreign affiliate that was redeemed, acquired or cancelled by the foreign affiliate in the course of the liquidation and the dissolution would be deemed to be nil;

7. generally, the foreign paid-up capital of a particular share of the capital stock of the foreign affiliate of the taxpayer resident in Canada in respect of the taxpayer would be the particular share's portion of the foreign paid-up capital of the class of shares of the foreign affiliate's capital stock to which the particular share belongs;

8. generally, the foreign paid-up capital of a particular class of shares of the capital stock of the foreign affiliate of the taxpayer resident in Canada would be the total amounts contributed by the foreign affiliate's shareholders to the foreign affiliate in respect of the shares of the class to which the particular share belongs, provided that those shareholder contributions were in respect of shares issued to or held by those shareholders;

9. however, in computing the foreign paid-up capital of a particular class of shares of the capital stock of the foreign affiliate of the taxpayer resident in Canada in respect of the taxpayer, where property other than money is contributed to the foreign affiliate in respect of shares of the particular class of shares of the foreign affiliate, the amount added in respect of that contribution of property to the foreign paid-up capital of the particular class of shares of the foreign affiliate in respect of the taxpayer would be determined by reference to the cost to the foreign affiliate of that contributed property, except that, where the contributed property is shares of the capital stock of another foreign affiliate of the taxpayer, the amount added would be limited to the foreign paid-up capital in respect of the shares of the other foreign affiliate of the taxpayer in respect of the taxpayer; and

10. the amounts required to be determined under that proposed subsection 88(3) and the related provisions of the Act would be determined in Canadian dollars because those amounts are relevant for Canadian tax purposes.

We propose to recommend to the Minister of Finance that such revisions to proposed subsection 88(3) of the Act and to the other relevant provisions of the Act apply to a liquidation and dissolution, of a foreign affiliate of a taxpayer resident in Canada, that begins after February 27, 2004.

Paragraph 95(2)(e.1) of the Act

In your correspondence, you expressed your views about two of the conditions to the application of paragraph 95(2)(e.l) to a liquidation and dissolution of a foreign affiliate (the "disposing foreign affiliate") of a taxpayer resident in Canada into another foreign affiliate of the taxpayer.

The first condition is the requirement that the taxpayer have a surplus entitlement percentage, in respect of the disposing foreign affiliate, of at least 90% immediately before the liquidation of the disposing foreign affiliate (the "90% SEP requirement"). You seek confirmation of our intention to recommend that, as an alternative to meeting the 90% SEP requirement, paragraph 95(2)(e.l) would be available where, immediately before the liquidation, a foreign affiliate of the taxpayer has a 90% or greater fair market value participating equity interest in the disposing foreign affiliate.

The second condition is the requirement that there be no gain or loss recognized, under the income tax laws of the country in which the disposing foreign affiliate was resident immediately before the liquidation, in respect of any property distributed by the disposing foreign affiliate in the course of the liquidation to another foreign affiliate of the taxpayer (the "non-recognition requirement"). You argue for the removal of the non-recognition requirement as a precondition to the application of paragraph 95(2)(e.1) so as to permit rollover treatment in respect of all property (rather than only excluded property) of the disposing foreign affiliate disposed of to any foreign affiliate of the taxpayer in the course of the liquidation and dissolution.

In your view, where proposed paragraph 95(2)(e.1) applies, that rollover treatment should be provided for by deeming the disposing foreign affiliate's proceeds of disposition of the property to be, subject to a relevant cost base election by the taxpayer, the cost amount of the property to the disposing foreign affiliate immediately before the liquidation.

From a tax policy viewpoint, we are sympathetic to the requests made for such revisions to the proposed paragraph 95 (2)(e.l). Although the technical details of our intended recommendations for modifications in respect of proposed paragraph 95(2)(e.l) and to the February 2004 foreign affiliate proposals in general are still being finalized, we can confirm, in general terms, that our recommended modifications in respect of that proposed paragraph 95(2)(e.1) of the Act would include the following modifications.

First, the recommended modifications to proposed paragraph 95(2)(e.1) would remove the non-recognition requirement that is a condition to the application of that paragraph.

Second, proposed paragraph 95(2)(e.l) would be amended to provide that it apply to a liquidation and a dissolution of a foreign affiliate (the "disposing foreign affiliate") of a taxpayer resident in Canada if one of the two following alternative tests is met by the taxpayer resident in Canada:

- The taxpayer would, immediately before the time of the earliest distribution of property by the disposing foreign affiliate in respect of shares of the capital stock of the disposing foreign affiliate in the course of the liquidation and the dissolution of the disposing foreign affiliate, have a surplus entitlement percentage in respect of the disposing foreign affiliate of not less than 90% (on the assumption that shares of the capital stock of non-resident corporations owned by any taxpayers resident in Canada and related (otherwise than by virtue of paragraph 251(5) (b) of the Act) to the taxpayer were attributed to the taxpayer.
- A foreign affiliate of the taxpayer that is a shareholder of the disposing foreign affiliate has a 90% or greater fair market value participating equity interest in the disposing foreign affiliate. It would be met if the total fair market value of the properties distributed in the course of the liquidation and dissolution by the disposing foreign affiliate to the shareholder foreign affiliate was not less than 90% of the total fair market value of the properties distributed by the disposing foreign affiliate to all of its shareholders.

Third, the recommended modifications to that proposed paragraph 95(2)(e.1) would provide that, where that paragraph applies to a liquidation and a dissolution of the disposing foreign affiliate of the taxpayer resident in Canada, the following rules would apply (except to the extent that subsection 88(3) would apply to the disposing foreign affiliate and the shareholder of the disposing foreign affiliate in respect of the distribution of the property):

- the disposing foreign affiliate would be deemed to have disposed of each property distributed, in the course of the qualifying liquidation and dissolution, to a shareholder of the disposing foreign affiliate that was, immediately before the distribution, a "specified purchaser" (within the meaning to be assigned by draft subsection 95(3.5}) in respect of the taxpayer resident in Canada for proceeds equal to the greater of
    - the "relevant cost amount" of the distributed property to the disposing foreign affiliate in respect of the taxpayer resident in Canada (being essentially the amount that would generally result in no gain or loss to the disposing foreign affiliate in respect of the taxpayer in respect of the disposition of the distributed property), and
    - where the disposing foreign affiliate is a controlled foreign affiliate of the taxpayer resident in Canada, the amount elected by the taxpayer (not exceeding the fair market value of the particular distributed property);
- any gain under subsection 40(3) of the Act of the shareholder from the disposition of a particular share of the disposing foreign affiliate that was redeemed, acquired or cancelled by the disposing foreign affiliate in the course of the liquidation and the dissolution would be deemed to be nil;
- the amounts required to be determined under paragraph 95(2)(e.l) would be determined in Canadian dollars where those amounts are relevant for determining the foreign accrual property income of the disposing foreign affiliate in respect of the taxpayer resident in Canada; and
- the rules listed earlier in this letter numbered as 2 to 9 would apply with necessary changes to fit the context of the shareholders of the disposing foreign affiliate being specified purchasers in respect of the taxpayer resident in Canada rather than the taxpayer.

Fourth, the recommended modifications to paragraph 95(2)(e.l) would clarify that paragraph 95(2)(e.1) applies (except to the extent that subsection 88(3) applies), to the disposing foreign affiliate and its shareholders that are specified purchasers in respect of the taxpayer resident in Canada, in respect of the distribution of the distributed property for the purpose of computing

- the foreign accrual property income, the surplus and tax accounts (as defined in subsection 5907 of the Income Tax Regulations) and the foreign paid-up capital, of the disposing foreign affiliate or any foreign affiliate of the taxpayer resident in Canada or any taxpayer resident in Canada that does not deal at arm's length with that taxpayer resident in Canada that are shareholders of the disposing foreign affiliate, in respect of those taxpayers, and
- the income or capital gains of a taxpayer resident in Canada that, at the time of distribution, was a specified purchaser in respect of the taxpayer resident in Canada and a shareholder (or a member of a partnership that was the shareholder) of the disposing foreign affiliate.

We propose to recommend to the Minister of Finance that these modifications to proposed paragraph 95(2)(e.l) of the Act and the related provisions apply to a liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada that begins after December 20, 2002, except if the taxpayer makes an election that applies in respect of all liquidations and dissolutions of its foreign affiliates. If the taxpayer makes that election, generally the proposals issued on February 27, 2004 would apply.

Thank you for writing.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch

Subject/Sujet:	Foreign Paid-Up Capital of Shares of a Foreign Affiliate and Distribution of Property
Date/Date:	June 9, 2006
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed] /LIR 88(3) [Proposé]

Dear xxxxx,

I am writing in response to your letter concerning proposed subsection 88(3) of the *Income Tax Act* (the "Act") m contained in the foreign affiliate proposals announced on February 27,2004. In your letter, you express your concern about the wording of draft subparagraphs 88(3)(e)(i) and (ii).

In your letter, you mention the situation where, prior to February 27, 2004, a corporation resident in Canada contributed cash, for no consideration, to a wholly-owned controlled foreign affiliate ("CFA") of the corporation as a contribution of capital in respect of the ordinary shares (common shares) of CFA. Under the relevant foreign corporation law, that capital contribution resulted in contributed surplus of the CFA. Pursuant to paragraph 53(1)(c) of the Act, the taxpayer's adjusted cost base of the ordinary shares of CFA held by the taxpayer increased because of that capital contribution.

You have also indicated that CFA would like to return the contributed surplus to the holders of its ordinary shares. You maintain that, under that foreign corporate law, CFA must make a bonus issuance of ordinary shares in order to increase the legal share capital (in this case, the par value) of those shares and reduce the contributed surplus in respect of the ordinary shares by the amount of the contribution of capital referred to above. CFA must then pass a resolution to make a pro rata reduction of the par value of all its Ordinary shares (including the bonus shares) the total of which would equal the amount of that contribution of capital.

You are concerned that the return of the par value in respect of a share would not meet the requirements under the February 2004 draft wording of proposed subparagraph 88(3)(e)(i) of the Act. This concern arises because the par value in respect of a share being returned to the holders of the ordinary shares was received by the CFA as a contribution of capital rather than on the issuance of ordinary shares.

We intend to recommend certain modifications to the proposed foreign affiliate amendments that, if acted upon, may address the concerns expressed. Under the modified rules, the taxpayer would be required to determine the foreign paid-up capital of each class of shares of a foreign affiliate of a taxpayer resident in Canada. The foreign paid-up capital of a particular share would be determined by dividing the foreign paid-up capital of the class by the number of issued and outstanding shares of the class. The total foreign paid-up capital of the foreign affiliate would be equal to the total foreign paid-up capital for all classes of shares of the foreign affiliate.

As well, the modifications will provide rules for the purposes of determining the foreign paid-up capital of a class of shares of a foreign affiliate of a taxpayer. The foreign paid-up capital of a class of shares of the foreign affiliate will, for example, be reduced by the amount of distributions made by the foreign affiliate as consideration for a return of the paid-up capital in respect of a share of the class. As well, rules are to be provided for the purpose of determining the amounts to be added in computing the foreign paid-up capital in respect of a class of shares of the foreign affiliate in respect of property received by the foreign affiliate for the issuance of shares of the class or as a contribution of capital in respect of shares of the class.

A foreign affiliate that notifies its shareholders that it is making a distribution of property to them as a return of all or a portion of the amounts included in the foreign paid-up capital in respect of shares of a particular class of the foreign affiliate can treat the distribution as a reduction of the foreign paid-up capital in respect of those shares rather than as payment of a dividend on those shares, to the extent that the foreign paid-up capital in respect of those shares exists immediately before the distribution. The distribution must have the same character for all shareholders of that class.

For example, in the situation you describe in your letter and assuming that all of the ordinary shares (other than the bonus shares) were issued for cash, the foreign paid-up capital, at any particular time, of the class of shares to which the ordinary shares belong would be determined as follows. There would be added the total of all amounts received, before the particular time, by CFA on the issuance of ordinary shares or as a contribution of capital in respect of the ordinary shares from holders of the ordinary shares. There would be deducted the total of all amounts paid, before the particular time, by CFA to the holders of ordinary shares as a return of the foreign paid-up capital in respect of those ordinary shares. The foreign paid-up capital, at any particular time, of a particular ordinary share would be determined by dividing the foreign paid-up capital, at that time, of the class to which the particular ordinary share belongs by the number, at that time, of issued and outstanding ordinary shares of that class.

It will be recommended that the above-mentioned modifications would apply to distributions made after February 27, 2004. However, if the taxpayer makes an election that applies in respect of all of its foreign affiliates, there would be a transitional version of new subsection 88(3) that would include a provision that would generally determine the paid-up capital of a class of shares of a foreign affiliate of the taxpayer and of a share of that class by reference to the amounts added under the relevant foreign corporate law to the paid-up capital or the contributed surplus in respect of the class of shares.

Thank you for writing.

Yours sincerely,

Brian Ernewein
Director Tax Legislation Division
Tax Policy Branch

Subject/Sujet:	Consequences of the Distribution of Property in Respect of Shares of the Disposing Foreign Affiliate
Date/Date:	June 9, 2006
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed], 95(2)(e.1) [Proposed] / LIR 88(3) [Proposé], 95(2)e.1) [Proposé]

Dear xxxxx,

I am writing in response to your letter dated May 4, 2006 with respect to proposed subsection 88(3) and paragraph 95 (2)(e.l) of the *Income Tax Act* (the "Act") as contained in the foreign affiliate proposals announced on February 27, 2004.

You were told, in our letter to you dated April 12, 2006, that we are considering modifications to proposed subsection 88(3) and paragraph 95(2)(e.l) of the Act that would characterize the amount of the distribution (determined in respect of a distribution of property in respect of a share of the capital stock of the disposing foreign affiliate) as a dividend paid on the share to the extent that the amount of the distribution exceeds the amount treated by the foreign affiliate as a reduction of the foreign paid-up capital in respect of the share.

You have asked, and we can confirm, that the portion of the amount of a distribution made in respect of a share that is treated by the foreign affiliate of a taxpayer as a reduction of the foreign paid-up capital in respect of the share (not exceeding the amount, immediately before the distribution, of the foreign paid-up capital in respect of the share) will not be a dividend under the foreign affiliate proposals and will reduce the shareholder's adjusted cost base of the share. The foreign affiliate will, therefore, be permitted to distribute property to the shareholder as a return of foreign paid-up capital in respect of a share determined in respect of the taxpayer prior to making distributions of property in respect of any existing surplus of the foreign affiliate determined in respect of the taxpayer.

The amount by which the amount of the distribution in respect of a share exceeds the portion of the amount of the distribution that is treated by the foreign affiliate as a reduction of the foreign paid-up capital in respect of the share is to be characterized as a dividend received by the shareholder on the share. The normal surplus distribution rules will apply to determine the portion of the dividend that is paid out of the various surplus pots of the foreign affiliate determined in respect of the taxpayer. To the extent that a dividend received on a share is paid out of the foreign affiliate's pre-acquisition surplus determined in respect of the taxpayer, the dividend will reduce the shareholder's adjusted cost base of the share.

I trust that these comments have provided the clarification requested. Thank you for writing.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch