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Dear Mr. Farber:

Proposed Amendments to Foreign Affiliate Rules in December 20, 2002 Draft Legislation

We are pleased to submit to you the enclosed Report of the Joint Committee outlining our principal comments in respect of the proposed amendments to the foreign affiliate rules released by your Department on December 20, 2002 (the "FA Proposals"). The Committee appreciates having the opportunity to work closely with the Department and to provide you with our comments to assist with the refinement of the FA Proposals. We also wish to register our understanding of how difficult this project is, and commend the Department for its considerable efforts and its willingness to consider many of our comments.

It is important to note that, in addition to commenting on the specific technical amendments contained in the FA Proposals, we have taken the opportunity in our Report to also catalogue various matters that have been identified over a number of years (many of which have been raised in previous communications of the Committee) related to other aspects of the foreign affiliate system that we hope will be addressed in due course.

The Committee's concerns, comments and suggestions are described in significant detail in the attached Report. However, we would like to draw your attention to a number of particular concerns that we have with respect to the FA Proposals:

- The first relates to the numerous proposals that address surplus computation issues. Since surplus computation is a central feature of the foreign affiliate system, we believe that changes in this area should be approached with considerable caution. Our recommendations in this area are set out in Section II of the Report.

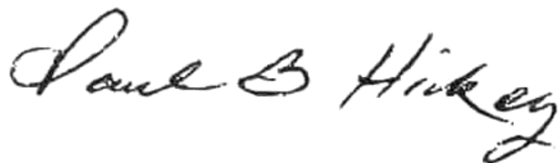
- Second, the distinctions between what qualifies as active income and other categories of income (i.e., income from an investment business and income from a business other than an active business) are also central to the functioning of the system. Thus, we feel that changes in this area should also be approached with considerable caution. We have made several recommendations with regard to such matters throughout our Report.

- Third, the proposed amendments to the fresh-start rules also give rise to concerns, to the extent that income and gains that have accrued during a passive period are taxed prior to their actual realization. This could result in material hardship. Our recommendations in this area are set out in Section III of the Report.

- Finally, we wish to register our continuing concerns with regard to the proposed coming into force provisions. In our view, there may be numerous circumstances in which the Global Section 95 Election could give rise to material hardship, and we therefore submit that this feature of the FA Proposals should be reconsidered. Our recommendations in this regard are set out in Section XIII of the Report.

We trust that you will find our comments and suggestions helpful in your efforts to develop and refine the FA Proposals. We look forward to continuing the dialogue with you that we have commenced on the FA Proposals.

Yours truly,



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cc. Mr. Brian Ernewein

REPORT OF THE JOINT COMMITTEE ON THE DECEMBER 20, 2002 FOREIGN AFFILIATE PROPOSALS

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I. Introduction

Policy foundations of the foreign affiliate and foreign accrual property income rules

The foreign affiliate ("FA") rules in the *Income Tax Act* (the "Act") and *Income Tax Regulations* (the "Regulations") reflect a balance of certain fairly fundamental fiscal policy objectives and constraints. It is sometimes difficult to fully reconcile these objectives and constraints, but overall the Canadian approach appears to the Committee to be well balanced in principle and not inconsistent with international norms.

On the one hand, the "foreign accrual property income" ("FAPI") rules appear to be intended to achieve full fiscal neutrality (i.e., both capital export neutrality and capital import neutrality) by attributing to relevant Canadian-resident shareholders, on an annual basis, the passive income and gains (and certain other types of income which are considered to reflect an erosion of the Canadian tax base) of a controlled foreign affiliate ("CFA"), net of the grossed-up amount of any underlying and withholding taxes borne by such income and gains, thereby preventing what is perceived to be the inappropriate deferral of taxes in respect of such income and gains. This is the aspect of the FAPI system that reflects capital export neutrality. Income and gains that have been taxed under the Act in this manner can then be distributed to relevant Canadian-resident corporate shareholders in the form of dividends without the imposition of further Canadian taxes. This is the aspect of the FAPI system that reflects capital import neutrality.

In contrast, although the "surplus" rules, at a minimum, provide relief (including tax sparing) in respect of any underlying and withholding taxes borne by the income and gains of a FA which are distributed to relevant Canadian-resident corporate shareholders in the form of dividends, these rules appear to be designed to be sensitive to the international competitiveness concerns of Canadian-based multinational enterprises. Indeed, the surplus rules seem to be oriented toward capital import neutrality, not capital export neutrality.

For example, the active business income of a FA (or of a CFA) is not attributed to relevant Canadian-resident shareholders on an annual basis, presumably because such attribution would place Canadian-based multinational enterprises at a competitive disadvantage relative to many of their foreign local competitors and their foreign-based multinational counterparts.[1] Although this aspect of the system is not consistent with capital export neutrality, based on the Committee members' experience, it is consistent with international norms. Although the Committee has not fully researched the matter, we are not aware of any major industrialized country that taxes the indirect active business income of its multinationals on an attribution basis.[2]

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[1] Essentially, this would be true in every case in which the effective rate of local tax (i.e., source-country tax) is lower than the effective rate of tax under the Act.

[2] Certain jurisdictions do not even tax direct foreign business income.

Once the policy decision is made to not attribute indirect active business income, the only remaining "big picture" issue which remains is whether or not to impose a "top-up" tax on foreign active business income when, and to the extent that, it is distributed to relevant Canadian-resident corporate shareholders (in the form of a dividend or otherwise).[3] In this regard, it has been the Committee members' experience that many foreign jurisdictions operate an exemption-based regime, while others operate a credit-based regime. Canada, like certain other countries, operates a more sophisticated, hybrid regime. Our system takes the exemption-based approach (i.e., "exempt surplus") where the relevant active business income is from a source in a treaty country and is earned by an affiliate that is resident in a treaty country.[4] Where the income is from a source that is not in a treaty country, or is earned by an affiliate that is not resident in a treaty country, our system takes the credit-based approach (i.e., "taxable surplus"). This is not at all inconsistent with international norms, based on the Committee members' experience.

Although the exempt surplus rules are generally premised on treaty-country residence,[5] and treaty-country source,[6] it would appear that there has been a long-standing policy that there is generally no requirement as such that the indirect active business income must in fact have borne any underlying taxes. Indeed, the Act was amended in 1949 to specifically eliminate the requirement that the income of a foreign subsidiary actually be subject to foreign tax as a condition of the exemption from Canadian tax for dividends paid out of such income to substantial corporate shareholders.[7]

Essentially, this is the element of the surplus rules that reflects capital import neutrality.[8] In principle, it would appear to be premised, in part, on the proposition that

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[3] We are not addressing the question of whether a "top-up tax" should be imposed on indirect foreign active business income when and to the extent that it is distributed to relevant Canadian-resident *individual* shareholders.

[4] In many other countries, principally in Europe, this is described as a "participation exemption" regime.

[5] This is not true, for example, in the context of international shipping companies (cf. subsection 250(6)).

[6] Foreign active business income that cannot be attributed to a permanent establishment in a non-treaty country is attributed to the affiliate's country of residence (cf. the definition of "earnings" in Regulation 5907(1)).

[7] Also eliminated at the same time was the requirement that the country where the foreign subsidiary resided granted *similar relief*, thereby making the exemption operate on a truly unilateral basis. Former paragraph 27(1)(d), as enacted by S.C. 1949 (2d Sess.), c. 25, section 12, subsequently (until 1972) paragraph 28(1)(d). Despite two major reconsiderations of the rules, in 1972 and in 1994, a general "subject to foreign tax" requirement has not been reintroduced as a condition of exempt surplus treatment.

[8] This element is reinforced by numerous other features of the rules. In addition to the general feature that exempt surplus treatment exists, Regulation 5901 deems dividends to be paid by a foreign affiliate first out of exempt surplus, and then only out of taxable surplus once exempt surplus is depleted. There is also the rule, in paragraph (b) of the definition of "underlying foreign tax applicable" in Regulation 5907(1), which permits the taxpayer to elect to allocate to a taxable surplus dividend a disproportionately high amount of the underlying foreign taxes paid by the affiliate. This permits at least some taxable surplus to be repatriated without the imposition of immediate Canadian taxes.

there should be no fiscal barrier under the Act to the repatriation of indirect treaty-country sourced active business income, because the effect of any such barrier would simply be to discourage the reinvestment of such income in Canada.[9] In addition, and again, this element of the surplus rules would also appear to reflect a policy decision to not in any way compromise the international competitiveness of Canadian-based multinationals relative to their foreign local competitors and their foreign-based multinational counterparts.

The approach to our recommendations

It is in this spirit of sensitivity to the duality of the Canadian approach that our concerns, comments and suggestions have been formulated. We have been guided by our recognition of the need to protect the Canadian tax base from erosion through inappropriate deferral of tax on passive income. At the same time, we have been guided by practical considerations, as well as by considerations arising with respect to the international competitiveness concerns of Canadian-based multinationals. As a rule, we have attempted to construct tailored solutions that are appropriate to each separate context, and not to inappropriately apply solutions from one context to the other.

For example, while we recognize the Department's concern reflected in proposed paragraph 95(2)(k.3), that income and gains which have accrued during a passive period should be taxed as such notwithstanding a change of status, we believe it is important for practical reasons to not introduce a rule which would impose tax on such income and gains before actual realization.[10] We also express the concern that it would be inappropriate to address surplus computation concerns that the Department may have in respect of the disposition of excluded property by the introduction of any rule which would cause the recognition of FAPI in that context. The forced attribution of FAPI is appropriate only in certain cases in the passive context, and not in the context of active business income and excluded property.

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[9] This would also appear to be the practical premise of the rulings issued by the CCRA to the effect that section 245 does not apply where a Canadian corporation borrows money from a foreign affiliate on an interest-free basis, even though the loan is funded using taxable surplus. Such an arrangement was rightfully not considered to result in a misuse of any provision of the Act or in an abuse having regard to the provisions of the Act read as a whole. See, for example, Ruling No. 9826443 (1998).

[10] Indeed, it would be completely inappropriate to have a rule which imposes tax on accrued passive income and gains before actual realization in the presence of the "blocked currency" exception to FAPI attribution in subsection 91(2). A shareholder of a CFA which had unrealized passive income and gains is in no better position to pay any tax than a shareholder of a CFA which is subject to foreign exchange controls.

II. Surplus Computation Issues

A large number of the provisions contained in the December 20, 2002 draft legislation that relate to foreign affiliates ("the FA Proposals") appear to be based on concerns that have arisen over surplus computation issues. Because surplus computation lies at the core of Canada's foreign affiliate system, it is important to understand these concerns in order to address how they should be reflected in any proposed legislation.

There appears to be four main concerns that arise in the context of surplus calculations. First, there is the question of *recognition*, and the concern that surplus be recognized at an appropriate *time*. Second, there is the question of *computation*, and the concern that the appropriate *amount* of surplus be recognized. Third, there is the question of *allocation*, and the concern that the recognized surplus be allocated to the appropriate surplus *account(s)*. Fourth, there is the question of *reorganization*, and the concern that certain transactions (including reorganizations, acquisitions, dispositions, mergers, etc.) involving foreign affiliates or relevant Canadian taxpayers give rise to appropriate *adjustments*.

A. Surplus duplication issues arising on dispositions of foreign affiliate shares under the current system

Surplus duplication – transactions on account of active business operations

Under the current rules, surplus arising from active business operations is generally recognized in accordance with timing and computation rules applicable under relevant foreign tax laws, subject to certain adjustments which are intended to reflect Canadian legal, tax and accounting principles. These adjustments are generally made under Regulation 5907(2), but there are other relevant provisions as well. Surplus arising from transactions on capital account is generally recognized in accordance with Canadian timing and computation principles, except that amounts relating to excluded property may be determined in the applicable foreign currency. Accordingly, in both cases, priority is given to Canadian timing and computation principles over foreign principles.

However, there are two exceptions to this proposition. The first is reflected in Regulations 5907(2)(f) and (j); the second is reflected in Regulation 5907(5.1).

Regulations 5907(2)(f) and (j) play an important role in adjusting an affiliate's earnings from business operations in accordance with Canadian principles. Essentially, they require an affiliate's surplus accounts to reflect any revenue, income or profit, or any loss, outlay or expense, from or relating to the business which is not otherwise required to be included or deducted in computing the affiliate's earnings from the business in accordance with the relevant foreign tax laws. However, these provisions do not apply where such items arise with respect to a disposition of property to another foreign affiliate of the taxpayer (or to a person with whom the taxpayer does not deal at arm's length) if, under the relevant foreign tax laws, a rollover or similar deferral provision applies to the disposition.

Similarly, although capital gains and losses are generally computed for surplus purposes in accordance with Canadian principles, Regulation 5907(5.1) displaces the Canadian principles in certain circumstances involving dispositions to another foreign affiliate of the taxpayer (or of a person with whom the taxpayer was not dealing at arm's length) if, under the relevant foreign tax laws, no gain or loss is recognized (either because of the application of a rollover or similar deferral provision, or otherwise) in respect of the dispositions.

The exact purpose of these surplus denial rules is not entirely clear. Why should there be surplus denial simply because the transaction results in non-recognition treatment under applicable foreign tax laws? These rules do not require that the transaction be taxable under applicable foreign tax laws. They simply require that recognition in respect of the transaction not be deferred under applicable foreign tax laws. Similarly, these rules do not require a transaction with an arm's length non-affiliate. Indeed, transactions with affiliates or non-arm's length parties do not necessarily result in surplus denial. They only result in such denial if, as noted above, under the relevant foreign tax laws, no gain or loss is recognized (either because of the application of a rollover or similar deferral provision, or otherwise) in respect of the relevant dispositions. Moreover, in the context of transactions on capital account involving operating assets, surplus duplication cannot be the concern, since the surplus consequences of such transactions are normally determined in accordance with Canadian principles. Accordingly, even in the absence of Regulation 5907(5.1), there could be no surplus duplication resulting from successive asset dispositions, because each transferee would get full basis in the transferred assets.

Similarly, in the context of income account transactions, Regulation 5907(2)(l) would preclude the duplication of any surplus by virtue of a subsequent disposition by a transferee, since it requires the deduction of any earnings that have already been accounted for in the hands of another affiliate under Regulation 5907(2)(f). It is also arguable that Regulation 5907(2)(j) would prevent surplus duplication on a subsequent disposition by a transferee, since it requires the deduction of relevant outlays or expenses, which should include the transferee's acquisition costs.

Surplus duplication – transactions on account of capital

The issues, however, are somewhat different in the context of dispositions of shares of other affiliates or partnership interests. In this context, there is the perennial additional issue of somehow accounting for the inevitable duplication of tax attributes at different levels of a chain of entities. Under current rules, this issue is addressed in part by rules such as subsection 93(1.1), which forces the extraction of surplus accounts on dispositions of shares which constitute excluded property. The effect of this rule is to eliminate any gain arising from the share disposition to the extent that such gain reflects undistributed surplus, thereby eliminating surplus duplication. In the absence of this rule, the shares of a foreign affiliate which constitute excluded property could be disposed of by one foreign affiliate to another without any actual subsection 93(1) deemed dividend election being made, which would result in the realization of surplus by the disposing affiliate, and such surplus would duplicate any existing surplus balances of the

transferred affiliate. However, subsection 93(1.1) does not fully address the challenges posed by chains of entities. For example, subsection 93(1.1) would not address the potential for surplus duplication that arises from a share disposition followed by an asset disposition.

Consider the following example: Canco holds FA1, which holds FA2 and FA3. FA2 has $100 of exempt surplus. FA2 also has appreciated assets which are used in an active business carried on in a designated treaty country, and is resident in such a country. The unrealized earnings accrued on those assets is $150. FA1 disposes of FA2 to FA3 for non-share consideration. FA1's adjusted cost base ("ACB") was $50, and the value of FA2 was $300 (consisting of the $50 original investment, the $100 of undistributed earnings, and the $150 of accrued unrealized earnings). FA1 would realize a gain of $250 except that, assuming the FA2 shares are excluded property, subsection 93(1.1) would apply to eliminate $100 of that gain by reducing the proceeds and substituting a deemed dividend. As noted above, this deemed dividend would eliminate any possibility of surplus duplication in respect of the $100 of FA2 *realized* surplus. However, subsection 93(1.1) would have no effect on the *unrealized* earnings which would remain capable of being accessed in FA2.

Assume that, subsequent to the transfer of the FA2 shares, FA2 disposes of its assets to an arm's length purchaser. FA2 will have cash equal to $300 (ignoring foreign taxes). FA2 will also have exempt surplus of $150 (assuming that appropriate adjustments are made to its surplus accounts to reflect the 93(1.1) deemed dividend). In addition, FA1 will have had a gain of $150, resulting in an additional $75 of exempt surplus. In total, following these transactions, there would be $325 of exempt surplus within the group, consisting of the $100 in FA1, which flowed up from FA2 on the share disposition, the $75 in FA1 which arose from the gain on the share disposition, and the $150 in FA2 which arose from the subsequent asset disposition. Moreover, FA1 will have another $75 of taxable surplus that arose from the gain on the share disposition, for a total surplus of $400.

This result is seemingly inappropriate. The result should be total exempt surplus of $250, exactly matching the realized and accrued earnings of FA2's business operations. This surplus should be situated in FA1, because FA1 has experienced a realization event with respect to its indirect interest in the underlying business operations that generated those earnings. In addition, since FA3 should get ACB in the FA2 shares equal to their value at the time of the transfer, there is no need for FA2 to have any surplus in order for that value to be extracted to FA3 without triggering any gain. It should be noted that we are not addressing the question of whether that surplus should be exempt or taxable, but rather only the question of where in the group it should be, and in what aggregate amount. The exempt/taxable surplus split question is addressed below.

Interestingly, and seemingly appropriately, this is exactly the result under the current rules if the sequence of the transactions described above is simply reversed. If FA2 first sells its assets to the arm's length purchaser, and only then (after a year end) does FA1 dispose of FA2 to FA3, the effect of subsection 93(1.1) would be to reduce FA1's proceeds by $250 by substituting a deemed dividend. This would result in the complete elimination of the gain in FA1, and the complete elimination of any possibility of surplus duplication. FA1 would have exempt surplus of $250, FA2 would have no realized or unrealized surplus, and FA3 would have ACB in the FA2 shares of $300, exactly matching their value. Moreover, the surplus of $250 in FA1 would exactly match the difference between the value of the FA1 shares ($300) and their ACB ($50), meaning that a subsequent gain on the FA1 shares would likewise be fully eliminated by subsection 93(1.1).

Surplus duplication – suggested approach

It would appear that a more complete solution to the surplus duplication dilemma would involve a comprehensive approach to matching "inside" and "outside" attributes in the context of a disposition of foreign affiliate shares or partnership interests. One version of such an approach might be structured along the following lines, using a share disposition as an example:

(i) Where shares of a particular foreign affiliate are disposed of to any person (or partnership) by the taxpayer or by another affiliate (or a relevant partnership), the relevant taxpayer would be permitted to elect that the transaction be recharacterized as an asset disposition followed by a share disposition.

(ii) If such an election is made, then the particular affiliate would be deemed to have disposed of (and to have reacquired) all of its property for fair market value, and to have had a year end before the relevant share disposition. Thus, subsection 93(1.1) would apply to fully eliminate the possibility of any duplication of surplus.

(iii) If such an election is not made by the taxpayer, then the current rules would apply, with one modification. That is, in computing the surplus of the transferred affiliate after the relevant share disposition, if the transferred affiliate continues to be a foreign affiliate of the taxpayer (or of a person with whom the taxpayer does not deal at arm's length), there would be deducted an amount equal to the gain realized by the transferor, and such deduction would be allocated between the transferred affiliate's exempt and taxable balances with reference to the relative values over (or under) the tax cost of its underlying assets.

In other words, a determination would be made as to the aggregate amount of exempt and taxable earnings or loss that would be realized on a sale of the underlying assets. The proportion of the gain realized by the transferor that the exempt earnings is of the total earnings which would arise, would be deducted in future computations of the transferred affiliate's exempt balances. The remaining

portion of the gain realized by the transferor would be deducted in future computations of the transferred affiliate's taxable balances.

(iv) It may also be possible to introduce rules which would facilitate internal reorganizations by permitting assets (be they operating assets or shares of other affiliates) to be transferred among and between foreign affiliates (and certain partnerships) for non-share consideration in an amount equal to the ACB of the relevant assets, rather than their fair market value, without triggering the application of any shareholder benefit or other recharacterization and adjustment rules, such as those in subsection 56(2), 69(1), 246(1) or 247(2), or section 67.

We note in this regard that the CCRA has reported issuing an advance income tax ruling to the effect that, based on technical and tax policy reasons, certain of these provisions did not apply to an "inadequate consideration" transaction (i.e., a transfer of assets for consideration equal to ACB which was less than FMV) between sister foreign affiliates.[11] Presumably, the CCRA also concluded that section 245 should not be applied.

There should not, in our view, be any material concerns about inappropriate value shifting transactions that such a rule might facilitate, provided that appropriate ACB adjustment rules are also introduced. In this regard, we recommend that paragraph 95(2)(f) and proposed paragraph 95(2)(f.1) be revised such that they would operate as cost, capital cost and ACB adjustment rules, rather than as income and gain or loss exclusion rules. Such a revision would provide for a proper base for earnings and FAPI calculations going forward.

Although this approach is not addressed in the FA Proposals, it is one that may produce the desired results when dealing with surplus duplication issues.

B. Surplus computation issues arising on share dispositions – proposed subsection 93(1.4)

One approach that may be effective, as an alternative to the FA Proposals in subsection 93(1.4) and its related provisions, for dealing with surplus arising on share dispositions could encompass the following attributes.

[11] This was reported by Jim Wilson at the Tax Executive Institute Conference held this May 2003. Jim Wilson indicated (on slides 10 and 11 of his presentation) that a ruling was recently issued by the CCRA to the effect that the various benefit conferral provisions in the Act would <u>not apply</u> to give rise to any FAPI in circumstances involving inadequate consideration transactions between foreign affiliates. Slide 10 explains that "technical and tax policy arguments support view that benefit provisions did not apply".

Suspension of gain or loss and the application of subsection 40(3)

For surplus computation purposes, any gain or loss otherwise resulting from the disposition of shares of a foreign affiliate that are excluded property by specified vendors to specified purchasers (defined essentially as under the current FA Proposals) would be suspended until such time as a release event occurs.

We feel that this measure should also apply to any gain arising by reason of the application of subsection 40(3) in respect of a specified vendor.

The current proposed subsection 93(1.4) would not apply to such a gain because subsection 40(3) does not deem the resulting gain to be from a disposition "to" any person, let alone to a specified purchaser. However, if a provision is introduced that would deem any gain resulting from the application of subsection 40(3) to be nil, the results may be inappropriate and complicated.

Subsection 40(3) results in a gain only where value is extracted from an affiliate (we note that stock dividends are essentially disregarded by reason of subsection 95(7) and the definitions of "amount" and "dividend" in subsection 248(1)), so the recipient affiliate must eventually realize equivalent surplus (i.e., "catch-up" surplus) or it will not be possible to subsequently extract that value from the recipient specified vendor without triggering a gain under subsection 40(3) on the shares of the recipient specified vendor (assuming it is another foreign affiliate of the relevant taxpayer). In effect, the result will be a form of double taxation in so far as either the original value or the value realized later to "catch-up" the denied surplus will effectively be taxed somehow.

A more appropriate approach would be to simply treat a subsection 40(3) gain in the same manner as any other gain (e.g., a gain resulting from a horizontal transfer). This would also avoid the need to develop complicated rules to track negative basis.

This surplus suspension approach would not address the possibility of surplus duplication arising because of unrealized income and gains "inside" the transferred affiliate.

Release events for recognition of suspended gain or loss

Where the surplus suspension approach applies, release events could include the following:

(i) The recognition of the gain or loss is not deferred for tax purposes, as a gain or loss either of the specified vendor or, in order to deal with partnerships and other fiscally transparent entities, of a direct or indirect member or shareholder of a specified vendor, under an applicable rollover provision of the income tax law of the country in which such specified vendor, member or shareholder, as the case may be, is resident. Having considered the matter, we have concluded that it would be appropriate to define recognition for tax purposes in this *negative* manner, along the lines of the current formulation in Regulation 5907(5.1) or 5907(2)(f). This negative formulation is deliberately intended to permit surplus

recognition where the specified vendor is resident in a country that does not have an income tax law. Indeed, deliberate amendments have been made to the Act and Regulations to introduce this negative formulation.

(ii) The taxpayer elects to recognize any such gain (but not any such loss) as a FAPI gain, in accordance with a relevant cost base concept along the lines of that in paragraph 95(2)(c), subject to the application of subsection 93(1) and similar rules.

(iii) There is a departure of a relevant entity from the relevant group. For example, if FA1 sells FA2 to FA3, then any gain or loss arising in FA1 is released for surplus computation purposes if any of FA1, FA2 and FA3 ceases to be a foreign affiliate of the relevant taxpayer or of a person with whom the taxpayer does not deal at arm's length (other than by a merger resulting in, or a liquidation into, such an entity). In this respect, in the context of FA1 ceasing to be within the group, we suggest that the surplus should be released before the time that FA1 so ceases to be within the group, so that such surplus can be used (for a subsection 93(1) election) on the disposition of the FA1 shares.

Election to treat certain share dispositions on a rollover basis

In certain circumstances, rather than adopting the surplus suspension approach, it may in our view be appropriate to deem a disposition of foreign affiliate shares by a specified vendor to a specified purchaser to have been made on a rollover basis, both for surplus computation purposes and more generally (i.e., for FAPI computation purposes), subject to a relevant cost base type election.

In particular, we are referring to circumstances in which the shares of a foreign affiliate are disposed of in a spin-off type transaction, by way of a dividend in kind or a return of capital. In such circumstances, it would be appropriate for the specified vendor to be considered to have disposed of the relevant shares for an amount equal to its ACB in the shares, and for the specified purchaser to be considered to have acquired those shares for that amount. To the extent that the ACB to the specified vendor of the relevant shares exceeds the ACB to the specified purchaser of its interest in the specified vendor and/or the surplus of the specified vendor, depending on whether the distribution is effected by way of a dividend or a return of capital, the specified purchaser would presumably be deemed to have realized a gain pursuant to subsection 40(3), which for surplus computation purposes would be treated as described above. Such an approach would closely mirror the approach currently reflected in paragraphs 95(2)(c) and (e), and would facilitate the implementation of foreign affiliate reorganizations. If such an approach were adopted, the amount of the related dividend/return of capital should be adjusted, to be deemed to be equal to the ACB of the relevant shares that were disposed of by the specified vendor. This adjustment is necessary to prevent the erosion of tax attributes in respect of the specified vendor.

Resulting surplus adjustments

Where 93(1) or similar rules apply to reduce the specified vendor's proceeds, appropriate adjustments should be made to the surplus and other accounts of the particular affiliate whose shares are disposed of, and of any other affiliate in which the particular affiliate has an equity percentage, all the way down the chain.

We feel that the adoption of such an approach would introduce additional complexity into an already overly complex system. However, it may not make as material a difference as it might have in the absence of the proposed amendment to Regulation 5905(7), which would prevent the elimination of "blocking deficits".

We note, however, that it is important to match inside surplus adjustments with outside basis adjustments. That is, to the extent that the surplus of an affiliate below the particular affiliate is reduced, then the ACB of that lower-tier affiliate's shares in the hands of the higher-tier affiliate must be increased, so that a gain does not result when the value formerly reflected as surplus of the lower-tier affiliate is eventually extracted to or realized by the higher-tier affiliate.

The ACB to the specified purchaser would equal the amount paid by the specified purchaser, regardless of whether a subsection 93(1) deemed dividend arose in the circumstances. This is appropriate because the specified purchaser needs that ACB in order to subsequently extract or realize the value in the excluded property shares in question. Where a gain arises by reason of subsection 40(3), then the holder's ACB in the relevant shares should be nil, since subsection 40(3) would only apply to the extent that value exceeding outside basis and inside surplus is extracted.

Presumably, suspended surplus accounts would have to be tracked and adjusted through foreign affiliate reorganizations much like normal surplus accounts are tracked and adjusted in accordance with Regulation 5905.

Given that suspended surplus accounts would have to be tracked as noted above, it may be appropriate for such accounts to be available for use for distributions among affiliates, even if the surplus would remain suspended in respect of distributions to Canadian resident corporations. In other words, with this alternative, such accounts would not be suspended in respect of distributions from one affiliate to another, but would be suspended for distributions into Canada. Such an approach would have the advantages of permitting suspended surplus accounts – and, more importantly, corresponding cash balances – to be moved around within a chain of affiliates, and would eliminate some of the problems which would otherwise arise because of subsection 40(3). In the latter context, we note that where an affiliate with suspended surplus pays a cash dividend to another affiliate, the other affiliate may have a gain because of subsection 40(3), which would give rise to additional suspended surplus, which would be duplicative. If suspended surplus were instead available for inter-affiliate dividends, this 40(3) issue should not arise. At the same time, taxpayers would not be able to use suspended exempt surplus to effectively repatriate cash originating in taxable surplus.

Netting of deficits and surpluses

If an amendment is being considered to net lower-tier deficits against higher-tier surpluses, we feel that such a change would not be appropriate. Conceptually, a 93(1) election is a proxy for the payment of an actual dividend. This amendment would produce a result that would be different from that which would arise if an actual dividend were paid.

At the very least, if this proposal is pursued, we suggest that, where a lower-tier deficit is applied against a higher-tier surplus balance, the ACB of the shares of the lower-tier affiliate must be reduced so that the loss reflected in the deficit and also reflected in the ACB of those shares is not duplicated. Moreover, in order to address circumstances in which lower-tier deficits were financed with debt, rather than equity coming in from another affiliate, we suggest that a lower-tier deficit be applied to reduce the surplus of a higher-tier affiliate only to the extent of the ACB of the higher-tier affiliate's shares of the lower-tier affiliate, since that is the only amount of the higher-tier affiliate's surplus which could ever reasonably be considered to have been lost (as reflected by the deficit).

Basis adjustments along the lines of those described above are not necessary under the current rules because those rules only make surplus adjustments at the top of the relevant chain in the context of a subsection 93(1) deemed dividend. While such adjustments would be necessary if the surplus netting approach were adopted, it would not be ideal, because surplus accounts are generally maintained in the currency of the country in which the relevant affiliate is resident, while ACB in respect of excluded property is generally maintained in the currency of the country in which the relevant shareholder of the relevant affiliate is resident. Thus, where these are different currencies (e.g., where the affiliate uses calculating currency A and its shareholder uses calculating currency B), affiliate surplus and shareholder basis are not functionally equivalent or interchangeable as tax attributes. Since the value reflected by the surplus has not been distributed, the better measure of that value is the affiliate's calculating currency, not the shareholder's calculating currency, so this approach, which substitutes shareholder basis for affiliate surplus, is not ideal.

C. Surplus computation issues arising on asset dispositions – proposed Regulation 5907(5.1)

We feel that the proposed amendment to Regulation 5907(5.1) should be reformulated so as to be consistent with the measures applicable to share dispositions, and to ensure that it does not apply to the transfer of shares of a foreign affiliate or to property sold in the ordinary course of the transferor's business.

In order to be consistent with the measures applicable to share dispositions, measures applicable to asset dispositions would presumably involve a similar surplus suspension/release mechanism as that described above. In other words, for surplus computation purposes, a gain or loss arising from the disposition of operating assets

would be suspended until such time as a release event occurred, and the release events applicable in this context would parallel those applicable in the context of share dispositions.

Thus, for example, where FA1 disposes of operating assets to FA2, then the surplus consequences otherwise arising would be suspended until either FA1 or FA2 ceases to be within the relevant group. Again, we suggest that, in the context of FA1 ceasing to be within the group, the surplus consequences of the prior asset transfer to FA2 should be released before the time that FA1 so ceases to be within the group, so that such surplus can be used (for a subsection 93(1) election) on the disposition of the FA1 shares.

We note that proposed Regulation 5907(5.1)(d), as currently drafted, would determine the ACB of share consideration received in exchange for the relevant transferred assets only for the purposes of Regulation 5907, and not for the purposes of the Act. Thus, for the purposes of the Act – and, in particular, for FAPI computation purposes, the ACB of such shares would arguably be equal to fair market value. We feel that this provision should be moved out of the Regulations and into the Act.

Another concern that should be addressed is that the Act does not currently provide for any rollovers for the transfer of operating assets in exchange for shares of a foreign affiliate, or for the transfer of any assets in exchange for partnership interests. Arguably, given that the Act contains rollovers (applicable exclusively in the foreign affiliate context or more generally) for share-for-share exchanges (i.e., paragraph 95(2)(c), section 51, subsection 85.1(5) and section 86) and mergers and liquidations (i.e., paragraphs 95(2)(d), (d.1), (e) and (e.1)), it seems difficult to see why it should not also contain rollovers for asset-for-share exchanges, or asset-for-partnership interest exchanges. With respect to the latter, we note that the introduction of section 93.1 and corresponding amendments have made the use of partnerships more attractive an alternative for Canadian-based multinationals and, accordingly, should be facilitated, by introducing a rollover provision.

D. Consolidated net surplus – proposed Regulation 5902(7)

If this particular measure is withdrawn, it will continue to be possible for subsection 93(1) deemed dividends arising on an inter-affiliate disposition to be supported by net surplus existing at any level within the chain of entities below the point of disposition. To address concerns with respect to outstanding higher-tier deficits arising under the current rules, revised surplus adjustment rules should be introduced, which would make such adjustments throughout the relevant chain of entities.

E. Blocking deficits – proposed Regulation 5905(7)

Under current rules, a deficit within a particular foreign affiliate does not survive the dissolution of the affiliate, thereby facilitating the elimination of "blocking deficits". Proposed Regulation 5905(7) is intended to address this concern by preserving a lower-tier deficit (and transferring it to a higher-tier affiliate having an interest in the lower-tier affiliate) upon the dissolution of a lower-tier affiliate.

We note that the current FA Proposal in this regard would appear to need some refinement. A foreign affiliate either has an amount of surplus, or it has an amount of deficit, within either the exempt or taxable stream, but not both. An affiliate can simultaneously have an exempt surplus account and a taxable deficit account, but it cannot have, in respect of the same taxpayer, both exempt surplus and an exempt deficit. Thus, for example, where the lower-tier affiliate's exempt deficit exceeds the higher-tier affiliate's exempt surplus, the current proposal would appear to have the effect of reducing the higher-tier affiliate's exempt surplus (by the amount thereof), but then to have no further effect in respect of the unapplied portion of the lower-tier affiliate's deficit. Arguably, in these circumstances, the unapplied portion of the lower-tier affiliate's deficit should result in a deficit in the higher-tier affiliate, or else that portion of the lower-tier affiliate's deficit will be eliminated.

F. Indirect acquisitions – proposed Regulations 5905(5.1) to (5.4)

We understand that there is some concern with respect to the simultaneous existence of both historical exempt surplus and a stepped-up cost base as a result of the application of the paragraph 88(1)(d) "bump" following an indirect acquisition of a foreign affiliate. However, the current proposal would appear to require some refinement. The purpose of these proposed amendments is to provide that the opening surplus, deficit and underlying foreign tax balances of a particular affiliate be adjusted to take into consideration an adjustment to the ACB of the shares of the affiliate pursuant to paragraph 88(1)(d). These proposals would appear to overlook somewhat the interaction between existing rules.

Proposed subsection 93(1.4) and its related adjustments for underlying realized surplus

In the context of proposed subsection 93(1.4) and in order to adjust for underlying realized surplus, proposed Regulations 5905(5.1) to (5.4) should apply as a function of the lower of, on the one hand, the amount by which outside basis has been increased and, on the other hand, the aggregate amount of inside net surplus. In other words, the surplus adjustment amount should be limited to the amount which the taxpayer would be permitted to deduct in computing its taxable income under paragraphs 113(1)(a) and (b) if the affiliate had paid a dividend immediately after the winding-up or amalgamation equal to its consolidated net surplus immediately before that time.

Proposed Regulation 5905(5.3) and its interaction with paragraphs 95(2)(f) and proposed (f.1)

Proposed Regulation 5905(5.3) does not distinguish between circumstances in which paragraph 95(2)(f) and proposed paragraph 95(2)(f.1) apply and those in which it does not. Paragraph 95(2)(f) applies where a gain or loss accrued before a particular non-resident corporation became a foreign affiliate of the relevant taxpayer (and certain other specified entities). Where it applies, it reduces any gain or loss subsequently realized by the amount thereof accrued before foreign affiliate status. Similarly, proposed paragraph 95(2)(f.1) would apply to reduce any income or loss subsequently realized by the amount thereof accrued before foreign affiliate status.

Because of subparagraph 95(2)(f)(vi), which refers to a predecessor corporation within the meaning of subsection 87(1), paragraphs 95(2)(f) and (f.1) would not apply where the paragraph 88(1)(d) bump is achieved through an amalgamation. In contrast, paragraphs 95(2)(f) and (f.1) might apply where the paragraph 88(1)(d) bump is achieved through a winding-up.[12]

Where paragraphs 95(2)(f) and (f.1) do apply, they should preclude the post-acquisition realization of surplus in an amount equal to the difference between the amount of the increase to ACB resulting from the paragraph 88(1)(d) "bump" and the surplus of the affiliate. Thus, Regulation 5905(5.3) would not be necessary, except to the extent of any surplus existing in lower-tier affiliates in which the top-tier affiliate has an equity percentage. Moreover, in such circumstances, this provision would have the effect of creating a "hole" in the affiliate's surplus accounts. In contrast, where paragraphs 95(2)(f) and (f.1) do not apply, proposed Regulation 5905(5.3) reflects an approach that is not ideal, as outlined below.

These proposals would make adjustments only at the level of the top-tier affiliate, not all the way down the relevant chain of entities. Thus, proposed Regulation 5905(5.3) should result in a deficit in the top-tier affiliate equal to the proportionate underlying surplus in lower-tier affiliates. As an alternative to this approach, and to be consistent with other surplus adjustment rules in Regulation 5905 (such as Regulation 5905(1), and the approach adopted in the context of proposed subsection 93(1.4)) we feel that proposed Regulation 5905(5.3) should be withdrawn and, instead, a measure should be introduced which would make appropriate adjustments to accounts all the way down the relevant chain of entities. This would not be our preferred approach, because it would have to involve the substitution of outside basis for inside surplus all the way down the relevant chain of entities, but it would be consistent with other surplus adjustment rules.

[12] These provisions would not apply, even in the context of a winding-up, if the non-resident corporation was a foreign affiliate of the taxpayer before the acquisition preceding the winding-up (e.g., if the "parent" held 10% of the shares of the non-resident corporation and then acquired control of the "subsidiary" which also held shares of the affiliate). Whether or not the list of entities other than the taxpayer descried in paragraph 95(2)(f) should be revisited is another matter of potential concern.

The approach reflected in proposed Regulation 5905(5.3), which is common to proposed Regulations 5905(5.1) to (5.4), is not the ideal approach because it involves the substitution of outside basis for inside surplus – which, once again, can create problems because of foreign exchange fluctuations. This concern is magnified in this context because the outside ACB would be that of a Canadian resident, and therefore would be determined in Canadian dollars rather than in some foreign calculating currency. As noted above, since the value reflected by the surplus has not been distributed, the more accurate measure of that undistributed value is in the calculating currency of the affiliate. This would suggest that, instead of reducing the affiliate's surplus, the amount by which outside basis can be stepped-up under paragraph 88(1)(d) should be reduced. This would give priority to inside surplus over outside basis. It appears that the reduction to the amount by which outside basis can be stepped-up under paragraph 88(1)(d) should be equal to the amount which the taxpayer would be permitted to deduct in computing its taxable income under paragraphs 113(1)(a) and (b) if the affiliate had paid a dividend immediately after the winding-up or amalgamation equal to its net surplus immediately before that time.

Changes needed to reflect a reduction of an inside deficit

None of proposed Regulations 5905(5.1) to (5.4) would apply to reduce an outstanding deficit after an acquisition. Thus, the proposals seem to be asymmetrical. That is, the paragraph 88(1)(d) "bump", which increases basis up to fair market value, is mirrored by the rule in paragraph 111(4)(c), which reduces basis down to fair market value. By analogy, proposed Regulations 5905(5.1) to (5.4) should be mirrored by rules which would reduce an inside deficit. In a sense, an inside deficit can be conceptualized as "negative basis". Thus, if the rule in paragraph 111(4)(c) did not apply, the excess outside basis would be compensated by the inside deficit (i.e., the negative basis). However, where the rule in paragraph 111(4)(c) does apply, thereby reducing the excess outside basis, there is nothing for the inside deficit to compensate, so to leave the inside deficit intact is to create a tax attribute "hole", which is inappropriate. We note that Regulation 5905(1), which applies in respect of a change in surplus entitlement percentage arising upon a direct (as opposed to indirect) acquisition of shares of a foreign affiliate, adjusts <u>both surplus and deficit</u> accounts.

Concerns if ownership of affiliate's shares is less than 100%

Another concern relates to the insensitivity of the current proposals in respect of issues arising where less than 100% of the shares of the relevant affiliate are held by the relevant taxpayer. That is, the current proposals would reduce inside surplus by the actual amount of the outside basis step-up, and no more. This is inadequate where less than 100% of the shares of the relevant affiliate are held by the relevant taxpayer because it does not reflect the taxpayer's surplus entitlement percentage.

For example, if an affiliate has $100 of surplus, and the taxpayer's surplus entitlement percentage is 60%, then the taxpayer's surplus entitlement is $60, not $100. If the taxpayer (indirectly) acquires another 30%, say for $30, the taxpayer's outside basis is increased by $30, and the current proposals would reduce inside surplus by $30,

leaving $70 of surplus intact. However, the taxpayer's surplus entitlement percentage would have become 90%, so the taxpayer's surplus entitlement would be $63 (i.e., $70 x 90%). This would result in the taxpayer having aggregate tax attributes equal to $93 (i.e., $63 of surplus entitlement and $30 of outside basis), which is too much.

The appropriate amount for aggregate tax attributes would be $90 (i.e., $60 of pre-existing surplus entitlement and $30 of new outside basis). To achieve this result, it would be necessary to increase the amount by which inside surplus is reduced, by a factor reflecting the reciprocal of the taxpayer's surplus entitlement percentage after the acquisition. Thus, in the above example, since the taxpayer's surplus entitlement percentage after the acquisition is 90%, the reciprocal of that percentage (i.e., 1/0.9) is approximately 11.11%. Thus, the amount by which inside surplus should be reduced (or by which the outside basis step-up should be decreased) is $30 (the amount of the potential increase to outside basis) increased by approximately 11.11%, or $3.33, for an aggregate amount of approximately $33.33. Thus, after the acquisition, the taxpayer would have new outside basis of $30, and the affiliate would have remaining inside surplus of approximately $66.67, of which 90% (i.e., the taxpayer's surplus entitlement percentage) is approximately $60, for an aggregate amount of tax attributes equal to $90 (i.e., $60 of pre-existing surplus entitlement and $30 of new outside basis), which is the appropriate amount.

As a cross-check, we note that this is also the amount of aggregate tax attributes which would result by virtue of the application of Regulation 5905(1) in respect of a change in surplus entitlement percentage arising upon a direct (as opposed to indirect) acquisition of shares of a foreign affiliate. That provision, which apparently assumes the taxpayer would get new outside basis, would adjust inside surplus to the proportion thereof otherwise determined that the taxpayer's surplus entitlement percentage before the acquisition is of the taxpayer's surplus entitlement percentage after the acquisition (i.e., in the above example: $100 x 60%/90% = $66.67).

Proposed Regulations 5905(5.2) and (5.4) and adjustments to underlying foreign tax

If indeed the result that would be obtained under Regulation 5905(1), in the context of a direct acquisition, is the appropriate benchmark, which we believe to be true in this regard, then another concern arises with respect to the FA Proposals, this time with reference to proposed Regulation 5905(5.4). This provision would adjust underlying foreign tax as a function of the adjustment to taxable surplus. In contrast, Regulation 5905(1) would adjust underlying foreign tax even in the absence of any adjustment to taxable surplus – that is, where taxable surplus arose, and foreign taxes were paid, and then that taxable surplus was eroded by losses but for some reason (i.e., loss carry-back period limitations) the underlying foreign tax was not completely recovered.

For example, if a foreign affiliate has $100 of earnings and pays $40 of foreign tax in year 1, then it will have taxable earnings and taxable surplus of $60 and underlying foreign tax of $40. If in year 5 the affiliate incurs a loss of $60, that loss may not be capable of being applied against the prior income under foreign tax law so as to generate a refund reducing the underlying foreign tax account. In such a case, the affiliate would

have a taxable loss of $60 and this would result in nil taxable surplus, but the $40 of underlying foreign tax would remain, and would therefore be adjusted by Regulation 5905(1) even if there was no adjustment to taxable surplus. In order to achieve consistency with Regulation 5905(1), it would be necessary for proposed Regulation 5905(5.4) to adjust underlying foreign tax independently of any adjustment to taxable surplus, on the basis of the proportionate change to the taxpayer's surplus entitlement percentage or an analogous fraction.

Similarly, proposed Regulation 5905(5.2) should arguably adjust taxable surplus even in the absence of any underlying foreign tax. Proposed Regulation 5905(5.2)(c) would limit the adjustment to the lower of other amounts and the grossed-up amount of the affiliate's underlying foreign tax. In other words, as with Regulation 5905(1), all accounts should be adjusted, independently.

Moreover, in the context of adjusting underlying foreign tax to reflect an increase in outside basis, the relationship between taxable surplus and the value of the underlying tax (i.e., the conversion ratio) should be described more accurately as the relevant tax factor minus one, not simply the relevant tax factor (see the descriptions of B in proposed Regulation 5905(5.2)(c) and in proposed Regulation 5905(5.4)). This is because what is being determined is the "tax-paid taxable surplus", so to speak, on the theory that it is equivalent to exempt surplus. Thus, the gross-up factor should be the same at the one used in paragraph 113(1)(b), which is the relevant tax factor minus one.

This is appropriate because taxable surplus represents earnings minus taxes. For example, if the affiliate had taxable surplus of $60, and underlying foreign tax of $40, and the gross-up factor used in paragraph 113(1)(b) was 1.5 (computed as 1/40%, minus one), then the affiliate's tax-paid taxable surplus (i.e., the amount of taxable surplus it could receive without paying Canadian tax) would be $60, so it would be appropriate to reduce taxable surplus by that amount. In contrast, if the adjustment is made in accordance with the relevant tax factor alone (as opposed to the relevant tax factor minus one), then taxable surplus would be reduced by $100 (instead of $60), which exceeds the tax paid amount and is therefore inappropriate, unless and except to the extent that the premise of the adjustment is proportionality as in Regulation 5905(1).

In addition, we note that proposed Regulation 5905(5.4) would not make any adjustments whatsoever to account for underlying foreign tax at levels below the top-tier affiliate, even though, as currently drafted, proposed Regulation 5905(5.3) would make adjustments to account for lower-tier taxable surplus. For example, if new outside basis in the shares of a top-tier affiliate (FA1) was increased by $30, and FA1 had no surplus but held all the shares of FA2, which had $100 of tax-paid taxable surplus (i.e., $100 of taxable surplus and underlying foreign tax of $66.67 (assuming a 40% base rate)), and the taxpayer's surplus entitlement percentage was 60% before the acquisition and became 90% after the acquisition, then current Regulation 5905(5.3) would create a deficit in FA1 equal to $30, which is inappropriate for the variety of reasons described above. It is also inappropriate because it does not reflect, and neither does proposed Regulation 5905(5.4), the underlying foreign tax in FA2.

Accordingly, if after this adjustment FA2 paid a dividend to FA1 equal to $100, FA1's taxable surplus would be $70 (though, as we have noted, this should be $66.67) and its underlying foreign tax would be $66.67, which is too much. In contrast, if these tax attributes were directly in FA1, then proposed Regulation 5905(5.2) would reduce FA1's taxable surplus of $100 to $70 (though it should be $66.67) and proposed Regulation 5905(5.4) would reduce FA1's underlying foreign tax of $66.67 by $20 to $46.67 (assuming that it is corrected to refer to the relevant tax factor minus one). However, it should be reduced by approximately $22.22, resulting in underlying foreign tax of approximately $44.45.

Regulation 5905(1) and basis adjustments for lower-tier surplus adjustments

Regulation 5905(1) does not provide for any basis adjustments which would correspond to lower-tier surplus adjustments otherwise provided for. Consider the following. The taxpayer holds 60% of FA1, which holds 100% of FA2, so the taxpayer's surplus entitlement percentage in FA2 is 60%. FA2 has $100 of exempt or taxable surplus in respect of the taxpayer. The taxpayer then acquires an additional 30% of FA1, such that its surplus entitlement percentage increases to 90%. As noted above, this rule (if revised along the lines described above) will have the effect of reducing FA2's exempt or taxable surplus to $66.67. However, FA2 still has value equal to $100, and FA1 still holds 100% of FA2, so if FA2 pays a dividend equal to $100, FA1 will receive all the dividend but only $66.67 will be considered to have been paid out of FA2's exempt or taxable surplus, the balance being considered to have been paid out of its pre-acquisition surplus. This balance would give rise to a gain in the hands of FA1, in the amount of $33.33, resulting in FAPI if the FA2 shares are not excluded property at that time and, in any event, in additional surplus (subject to suspension as described above) if the FA2 shares are excluded property at that time. Arguably, this result is inappropriate, and could be avoided by simply increasing the basis to FA1 of the FA2 shares by the same amount by which the surplus of FA2 is reduced (i.e., $33.33). We feel that Regulation 5905(1) should be amended as part of the current round of revisions in order to address this concern.

G. First-tier liquidations – proposed description of "B" in the definition of FAPI

We believe that the reference to subsection 88(3) in the proposed description of "B" in the definition of FAPI should be withdrawn. We feel that this change is not necessary because a revenue base concern cannot arise in the context of a subsection 88(3) liquidation. No FAPI should arise unless the taxpayer makes a relevant cost base election and the distributed shares are not excluded property. To the extent that the taxpayer does make such an election, the revenue base is protected because increasing inside proceeds (by virtue of that election) would increase outside proceeds under paragraph 88(3)(b). Thus, the effect of this proposed amendment would simply be to substitute FAPI for increased outside proceeds, albeit at capital gains rates.

Accordingly, if the relevant taxpayer has capital losses which it could otherwise use against any gain resulting from the increased outside proceeds, as under the current rule and as is appropriate, it would not be able to use those losses against the FAPI under the proposed amendment, which is therefore inappropriate. The taxpayer should be permitted to use capital losses to shelter any gain resulting from increased outside proceeds because, in this context, we are dealing with capital property (which is what the description of B in FAPI deals with), not income.

H. Eligible capital property

Under the FA Proposals, new paragraph (a.1) is added to both the definition of "exempt earnings" and "exempt loss" in Regulation 5907(1). These provisions are intended to include in an affiliate's exempt earnings (or loss) the amount by which 50% of a relevant affiliate's proceeds of disposition exceed (or are exceeded by) its cost in respect of any disposition of excluded property that is eligible capital property, minus any portion of such amount as has already been included in the affiliate's exempt earnings (or loss).

We are concerned that this proposal, as currently drafted, would not achieve the desired result. First, the consequences of the disposition of eligible capital property would depend on whether the property was excluded property, and also on whether such excluded property was property of an active business rather than property of an investment business. Second, where the consequences of the disposition of eligible capital property are determined in accordance with the provisions of the Act (rather than primarily under foreign tax law), these consequences would be determined in accordance with subsection 14(1), on the basis of a pooling mechanism, and not on a property-by-property basis. Thus, in making adjustments to earnings to reflect the tax-exempt portion of the gain from a disposition of eligible capital property, reference should be made to the pooling mechanism applicable under subsection 14(1). Third, this proposal should be reformulated to account for the exempt portion of the gain from a disposition of eligible capital property that is not excluded property. Fourth, additional amendments should be made to Regulation 5907(2), in order to ensure that no more than 50% of the gain from the disposition of eligible capital property which is excluded property of an active business carried on in a non-treaty country (other than Canada) should be included in taxable earnings, notwithstanding the provisions of foreign law, and that the balance is included in exempt earnings.

The effect of the current draft provision is not clear. If, for example, a foreign affiliate disposes of eligible capital property which is used or held in the context of an investment business to earn income from an active business under paragraph 95(2)(a), one half of the affiliate's gain will be included in its income from an active business under subparagraph 95(2)(a)(v) and in its exempt earnings under clause (d)(ii)(L) of the definition of "exempt earnings" in Regulation 5907(1). Then, in applying proposed paragraph (a.1) as indicated above, there would not appear to be any amount by which 50% of the taxpayer's gain exceeds the amount already included in its exempt earnings.

If the excluded property is property of an active business (rather than an investment business), then no amount in respect of the disposition of that property would be included in computing the affiliate's income from an active business under subparagraph 95(2)(a)(v) and in its exempt earnings under clause (d)(ii)(L) of the definition of "exempt earnings" in Regulation 5907(1). This is because these provisions apply only to income that would otherwise be income from property, and a gain realized on the disposition of eligible capital property of an active business would not otherwise be income from property. However, that is not to say that no amount in respect of the disposition of eligible capital property of an active business would be included in computing the affiliate's exempt earnings. If the earnings of the affiliate must be computed in accordance with foreign income tax law, then anything from nil to 100% of the affiliate's profit might be reflected in its earnings, depending on the foreign tax rules. If anything less than 100% is reflected in earnings computed in accordance with the foreign tax laws, then the balance should arguably be added in accordance with Regulation 5907(2)(f), subject to its terms and conditions. Thus, once again, there is no scope for the application of proposed paragraph (a.1) of the definition of "exempt earnings". Finally, in the context of eligible capital property of an active business, where the earnings of the affiliate must be computed in accordance with the Act, then 50% of the affiliate's profit would be reflected in its earnings. Again, there seems to be no scope for the application of proposed paragraph (a.1) of the definition of "exempt earnings".

These examples illustrate some of the concerns that arise in the context of the current proposals, but do not reflect further complexities which arise because of the pooling mechanism in subsection 14(1), or in circumstances involving eligible capital property which is excluded property of an active business carried on in a non-treaty country (other than Canada).

I. Definitions of "exempt earnings" and "exempt loss" – proposed clauses (d)(ii)(L) and (c)(ii)(L)

Proposed clauses (d)(ii)(L) of the definition of "exempt earnings" and (c)(ii)(L) of the definition of "exempt loss" in Regulation 5907(1) are intended to correspond to proposed subparagraphs 95(2)(a)(v) and (vi). These provisions do not seem to distinguish between property used to earn active business income that is included in exempt earnings, and property used to earn active business income that is included in taxable earnings. We feel that this distinction should be addressed by incorporating the appropriate language in these provisions.

J. Consistency of surplus calculations – proposed Regulation 5907(2.7)

Regulation 5907(2.7) sets out a timing rule which provides that where an amount, which is included in an affiliate's income from an active business for a particular taxation year under subparagraph 95(2)(a)(i) or (ii), is in respect of an amount paid or payable (other than an amount described in clause 95(2)(a)(ii)(D)) by another non-resident corporation described in subparagraph 95(2)(a)(i) or (ii), or by a partnership of which such a corporation is a member, the amount must be deducted in computing the active earnings or loss of the payor for its earliest taxation year in which the amount became paid or payable, and not for any other taxation year. The FA Proposals expand the scope of this provision by replacing the references to subparagraph 95(2)(a)(i) or (ii) with references to paragraph 95(2)(a).

The purpose of this amendment is not entirely clear, given that proposed subparagraphs 95(2)(a)(iii) to (vi) do not provide for an inclusion which is contingent on an amount being deductible by the payor. On the other hand, Regulation 5907(2.7) does not require the inclusion to be contingent on a deduction, only that the inclusion be "in respect of" an amount paid or payable. Thus, where, for example, one affiliate sells eligible capital property which is excluded property to another affiliate and an amount is included in the seller's income under subparagraph 95(2)(a)(v), then it seems that Regulation 5907(2.7) may require an equivalent deduction in computing the purchaser's active business earnings or loss, even if the property in question is capital property (i.e., is not inventory or eligible capital property) to the purchaser. This may not be an appropriate result in certain circumstances.

K. Other Matters

There are a number of additional concerns that arise, in relation to the current surplus computation and related rules, which the FA Proposals do not address. In brief, they include the following:

Regulation 5907(13)

There is a long-standing concern that Regulation 5907(13) gives too little relief for hypothetical foreign tax because the formula therein is based on the relevant tax factor minus one, when it should simply be based on the relevant tax factor. This treatment is different from proposed Regulations 5905(5.2) and (5.4) where the foreign tax has been paid. In Regulation 5907(13), the foreign tax is hypothetical.

In a Technical Interpretation dated October 3, 2000 (2000-0015565), the CCRA acknowledged that the hypothetical tax mechanism applicable under Regulation 5907(13)(b) for the purposes of the deemed FAPI inclusion on the immigration of a foreign affiliate is defective and that the Department of Finance is aware of the problem and considering the introduction of a relieving amendment.

Surplus entitlement percentage

There is a problem with the determination of a taxpayer's surplus entitlement percentage where a higher-tier deficit blocks lower-tier surplus and there is more than one class of shares in each relevant affiliate. We understand that the Department is aware of this problem.

Surplus adjustments when subsection 93(1) elections are made

The rules, which adjust underlying surplus to account for 93(1) elections, do not always produce the appropriate erosions. For example, there seems to be no adjustment for the use of a 93(1) election in relation to a gain realized by making a relevant cost base election under paragraph 95(2)(d) in the context of a foreign merger. This would appear to be the case because Regulation 5905(3) does not have such an adjustment rule, in contrast to other rules in Regulation 5905. If no such adjustment is made, the surplus in a predecessor corporation can be accessed (e.g., to step up outside basis) using a 93(1) election upon the merger, but then would remain available for additional use under subsection 93(1) or otherwise after the merger, which is inappropriate duplication. This is just one example.

Interaction of subsection 91(5) and section 92

There is a problem in the interaction of subsection 91(5) and section 92 in respect of all taxpayers where the shares which had a basis adjustment under section 92 have been substituted on a rollover basis, whether on a share-for-share exchange or on a liquidation or merger. Because subsection 91(5) does not have a substituted share rule, this deduction is lost. It is our recommendation that this concern be addressed by adding a substituted share rule to subsection 91(5).

Interaction of subsection 91(5) and paragraph 113(1)(b), and subsections 93(2) and (4)

There is a problem with the interaction between subsection 91(5), paragraph 113(1)(b) and subsections 93(2) and (4). The latter limit losses (and basis adjustments) based on previously received exempt dividends. For these purposes, dividends which are deductible under subsection 91(5) are not exempt dividends, but dividends which are deductible under paragraph 113(1)(b) are exempt dividends. Thus, in the context of previously-taxed FAPI, since both deductions can apply, the deduction is distributed as between 91(5) and 113(1)(b), depending on the extent to which foreign tax has been paid. The more foreign tax which has been paid, the more the deduction is allocated to paragraph 113(1)(b) rather than subsection 91(5).

Therefore, the extent to which the stop-loss rule in subsection 93(2) applies generally depends entirely on the extent to which the tax which has been paid by the taxpayer (either directly or indirectly, in either case in the same overall amount) has been paid to Canada versus to a foreign country. The exception is where the underlying tax is Canadian tax, say under Part I or Part XIII, because the affiliate has Canadian-source FAPI. In this case, the extent to which the stop-loss rule in subsection 93(2) applies will depend entirely on the extent to which the tax which has been paid by the taxpayer (in

both cases in the same overall amount) has been paid to Canada by the affiliate (and, therefore, indirectly by the taxpayer) versus being paid to Canada directly by the taxpayer. It is our recommendation that this concern be addressed by repealing subsection 93(2), or, at a minimum, by amending the definition of exempt dividends so that it excludes dividends deductible under paragraph 113(1)(b) to the extent that the deduction can reasonably be considered to relate to tax paid under the Act. For further discussions relating to subsection 93(2), see Section IV dealing with foreign exchange issues on page 34.

The definition of "exempt dividends" in subsection 93(3) includes dividends deductible under paragraph 113(1)(b) in respect of not only grossed-up foreign taxes incurred in relation to the relevant FAPI, but also in respect of any grossed-up Canadian taxes incurred in relation to the relevant FAPI. We believe that this definition should be amended in order to exclude dividends deductible under paragraph 113(1)(b) to the extent that it may reasonably be considered that such deductions relate to amounts paid under the Act. Dividends deductible under subsection 91(5) are distinguished from dividends deductible under paragraph 113(1)(b) in the context of subsections 93(2) and 93(4) because the former, but generally not the latter, reflect amounts which have already been taxed under the Act. The definition, however, fails to distinguish between dividends deductible under paragraph 113(1)(b) because of the imposition of foreign taxes and dividends deductible under paragraph 113(1)(b) because of the imposition of Canadian taxes. We feel that, from a tax policy perspective, the latter should be treated in the same manner for the purposes of the stop-loss rules as dividends deductible under subsection 91(5). This concern could be addressed by simply adding the following words after the reference to "paragraph 113(1)(a), (b) or (c)" in paragraph 93(3)(a):

> *"except to the extent that the amount in respect of the dividend that is so deductible can reasonably be considered to relate to an amount paid under this Act"*

Technical drafting point in subsection 93(4)

Subsection 93(4) contains a technical deficiency in its cross-reference to subsection 93(2). The current cross-reference is set out in subparagraph (ii) of the description of B in paragraph 93(4)(b). as follow: "the total of all amounts deducted <u>under paragraph (2)(d)</u> in computing losses of the vendor from the dispositions of the shares disposed of". This cross-reference is not accurate as subsection 93(2) was previously amended and no longer contains any paragraph 93(2)(d).

The consequences of this deficiency, in terms of its implications for the effectiveness of the stop-loss rule in subsection 93(4), are not entirely clear. If this deficiency affects the effectiveness of the cross-reference, then the entire amount of the loss that is denied under subsection 93(4) would be added to ACB under paragraph 93(4)(b), notwithstanding the prior receipt of exempt dividends. It is submitted that this concern can be addressed by replacing the language in subparagraph (ii) of the description of B in paragraph 93(4)(b) with the following language:

> “the total of all amounts deducted *by virtue of the description of B in subsection (2)* in computing losses of the vendor from the dispositions of the shares disposed of”.

Definition of "underlying foreign tax" and its application to foreign tax regimes

There is potentially a problem with respect to the interaction of the definition of underlying foreign tax (and that of foreign accrual tax) and foreign tax regimes that either disregard the existence of separate entities (such as US LLCs) or impose taxes under their own CFC rules (such as the US Subpart F rules). While recent CCRA interpretations are helpful in this regard, older ones are not helpful, particularly in the context of the application of foreign CFC rules. We trust that the Department is aware of this concern.

III. Fresh Start Rules

The FA Proposals contain a number of amendments to paragraphs 95(2)(k) to (k.6) that would substantially change the application of the fresh start rules. Of particular concern to the Committee are the proposed amendments which are intended to ensure that income and gains accrued during an active period are appropriately reflected for FAPI and surplus computation purposes, and the proposed amendments which would apply where a foreign business becomes an active business.

A. Accrued active income and gains

Proposed paragraph 95(2)(k) sets forth the criteria for the application of paragraph 95(2)(k.1), which replaces existing paragraph 95(2)(k). The proposed amendments would essentially apply to a foreign affiliate or partnership ("the operator") that changes from carrying on an active business to carrying on a business (a "Passive Business") which gives rise to income from property (i.e., an investment business, or a 95(2)(l) business) or income from a business other than an active business (i.e., a business described in any of paragraphs 95(2)(a.1) to (b)). This definition of Passive Business would represent an expansion of the fresh start rules as compared to the current definition of foreign business.[13]

We have identified the following concerns with respect to these proposed amendments.

Timing of deemed disposition of property

The timing of the deemed disposition of property used in the active business would be immediately before the beginning of the taxation year ("specified taxation year") in which the change from an active business to a Passive Business occurs. Thus, there would be a deemed disposition at the end of the year throughout which the business was an active business. This timing is perhaps somewhat inaccurate, in that income and gains accruing during the specified taxation year, but before the event that gave rise to the change in status occurs, would be treated as passive income and gains. We feel that this timing should be reconsidered, and that it may be more appropriate for an affiliate that experiences this type of change in the status of its business to be deemed to have had a year end immediately before the change, and to have had a deemed disposition immediately before that deemed year end. The adoption of such an approach would presumably also involve the introduction of corresponding changes to the Act that would permit a business to be an active business for part of a taxation year.

[13] A foreign business is currently defined in 95(2)(k) to include an investment business or a business deemed by 95(2)(a.1) to (a.3) to be a business other than an active business.

Application of rules to income from an active business

The current proposals would not appear to have any effect in the context of a Passive Business, or an activity that constitutes a source of income from property under general principles, which gives rise to income from an active business. For example, a particular affiliate may be carrying on an investment business involving lending, or the leasing or licensing of property, to another affiliate of the taxpayer in circumstances that would require the resulting income to be included in the particular affiliate's income from an active business. The affiliate's property used or held in respect of such activities should constitute excluded property. We suggest that accrued income and gains on such excluded property at the time that such property ceases to be excluded property should also be reflected, for FAPI and surplus computation purposes, as active income and gains.

Treatment of a taxable Canadian business

Proposed paragraph 95(2)(k.1) would not apply in the context of a "taxable Canadian business". The reason for this exclusion is not clear. A taxable Canadian business can be an active business or a business other than an active business. If a taxable Canadian business is an active business and then becomes a business other than an active business, there is no apparent reason why income and gains that accrued during the active period should not benefit from the treatment of paragraph 95(2)(k.1). Accordingly, we recommend that proposed paragraph 95(2)(k) be revised to delete proposed subparagraph 95(2)(k)(ii) and proposed clause 95(2)(k)(iv)(B).

Preamble in paragraph 95(2)(k.1)

The preamble in proposed paragraph 95(2)(k.1) refers to computing the affiliate's "foreign accrual property income in respect of the taxpayer from the foreign business". This reference would appear to be too narrow, and would not seem to render this provision applicable in computing the affiliate's FAPI from the disposition of property used or held in respect of the business. We therefore suggest that this reference be substituted with one that would clearly apply to both income from the business, and to income from the disposition of relevant assets.

Moreover, this deemed disposition should apply for all purposes, not just for purposes of computing the affiliate's FAPI. That is, this deemed disposition should apply:

- for the purpose of computing the affiliate's earnings and exempt earnings in respect of the business which has ceased to be an active business,
- for the purposes of computing the affiliate's FAPI thereafter, and
- for the purposes of computing any other amount which may be relevant thereafter.

Thus, the best approach may be for the relevant statutory language to simply state that the affiliate is deemed for all purposes, but only in respect of the taxpayer, to have disposed of (and to have reacquired) all of its property that relates to the business that has ceased to be an active business.

Concerns with proposed Regulation 5907(2.9)

As currently drafted, proposed Regulation 5907(2.9) would account for earnings arising in respect of reserves, recapture of depreciation, inventory, goodwill (at least in part) and resource properties. However, it would not account for any gain or loss in respect of appreciated capital property. We therefore recommend that this provision be revised to account for the exempt earnings and/or taxable earnings (or exempt and/or taxable losses) in respect of capital property. This should include any capital gain in respect of non-depreciable capital property and in respect of depreciable capital property, and any capital loss in respect of non-depreciable capital property.

As well, this rule as currently drafted would pick up only 50% of the gain on eligible capital property. We therefore recommend that this provision be revised to account for 100% of the gain on eligible capital property.

B. Accrued passive income and gains

The unexpected introduction of proposed paragraphs 95(2)(k.2) and (k.3) serve to substantially change the scope and object of the fresh start rules. The fresh start rules no longer function to provide equitable relief for taxpayers with affiliates that become subject to the FAPI regime because of the post-1994 definition of "investment business" and other rules. We feel that these new provisions represent a fundamental shift in tax policy by introducing a set of "change in use rules" that would apply in the opposite situation of the current fresh start rules. These new "change in use rules" bring within the reach of the FAPI regime unrealized income and gains that accrued prior to an affiliate changing its activities such that it thereafter carries on an active business. Previously, such income and gains were not subject to the FAPI regime and, consistent with the existing rules in section 95 and normal Canadian realization principles, took their character from the nature of the business in the year of a realization or recognition event. As a result of the introduction of these rules, we feel that taxpayers could potentially be subject to tax retroactively, exposed to premature taxation, subject to potential double-taxation without relief, and exposed to tax on an economic loss. We therefore put forth the following recommendations.

Timing of effective date for implementation of rules

To achieve taxpayer equity and to avoid imposing retroactive changes in policy and legislation, we suggest that the effective date for the implementation of paragraphs 95(2)(k.2) and (k.3) should be extended to specified taxation years commencing in 2006, and preceding taxation years commencing in 2005. Under this proposal, taxpayers would have the balance of 2003 and all of 2004 (i.e., approximately 18 months) to restructure investment businesses into active businesses without being subject to the new "change in use" rules. At a minimum, paragraphs 95(2)(k.2) and (k.3) should not apply prior to December 20, 2002, even if a Fresh Start Section 95 Election is made.

For the same reasons, we suggest that unrealized gains and income of a foreign affiliate that have accrued as at December 20, 2002 (the "safe start date"), would continue to be subject to the existing legislation. That is, to the extent that any portion of a gain or income in respect of property had accrued prior to the safe start date, that portion would not be subject to paragraph 95(2)(k.3), and would be characterized based on the nature of the business of the affiliate in the year that the relevant property is the subject of a disposition or deemed disposition (other than by reason of paragraph 95(2)(k.3)).

Timing and amount of FAPI recognition

We feel that the proposed amendments should be revised to defer the recognition of any FAPI until the relevant property is actually disposed of, which generally would coincide with the time when income and gains are recognized for foreign tax purposes. In this context, no distinction should be made between capital property and inventory or other types of property.

In addition, if this recommendation is not adopted, at a minimum any FAPI arising from the deemed disposition should be required to be reported in respect of the specified taxation year, not the preceding year. The taxpayer may not be aware that the business has become an active business until the end of the specified taxation year, which may be after the taxpayer is required to file its tax return in respect of the preceding year.

The proposed amendments should be revised to limit the amount of FAPI to be reported in such circumstances to the lesser of:

- the income or gain that accrued during the period that the affiliate was not carrying on an active business; and
- a portion of the income or gain actually realized on the ultimate disposition of the relevant property, determined as a function of the period during which the affiliate was carrying on an active business and the period during which the affiliate was carrying on a Passive Business.[14]

Implications to start-up companies and businesses that cease operations

We feel that the proposed amendments should be revised to accommodate business issues that are relevant for start-up companies and new ventures and that directly impact the international competitiveness of these companies. Specifically, we recommend that a grace period be introduced for newly formed affiliates, start-up operations and post-acquisition restructuring, so that paragraph 95(2)(k.3) would not apply in respect of businesses which become active within the first 3 years of their commencement or within the first 3 years of the affiliate becoming a foreign affiliate of the relevant taxpayer.

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[14] The approach could draw on the legislation currently in place for determining the principal residence deduction.

The proposed fresh start rules should also provide a grace period for businesses that are temporarily suspended, to ensure that no FAPI gains or losses are triggered on the subsequent re-start-up of business activities.

Changes in business activities

We submit that proposed clause 95(2)(k.2)(iv)(B) should be deleted, because proposed paragraph 95(2)(k.3) should apply only where the business has become an active business. Where the business has not become an active business, then the accrued income and gains in respect of the relevant property will not disappear into exempt earnings upon actual disposition, so there should not be any need to accelerate the recognition of such earnings and gains. Moreover, paragraph 95(2)(k.3) should not apply where a Passive Business has ceased to constitute a business but has not become an active business – for example, where the activity level has dropped to the point that the affiliate's activities no longer constitute a business but rather constitute a source of income from property under general principles.

Preamble in paragraph 95(2)(k.3)

The preamble in proposed paragraph 95(2)(k.3) refers to computing the affiliate's "foreign accrual property income in respect of the taxpayer <u>from</u> the foreign business". This reference would appear to be too narrow, and would not seem to render this provision applicable in computing the affiliate's FAPI <u>from the disposition of property</u> used or held in respect of the business. We therefore suggest that this reference be substituted with one that would clearly apply to both income from the business, and to income from the disposition of relevant assets.

Moreover, this deemed disposition should apply for all purposes, not just for purposes of computing the affiliate's FAPI. Thus, as with proposed paragraph 95(2)(k.1), we recommend that the relevant statutory language be revised to state that the affiliate is deemed for all purposes to have disposed of (and to have reacquired) all of its property which relates to the foreign business which has become an active business.

Lack of equivalent provision such as proposed Regulation 5907(2.9)

There is no Regulation that would clearly account for the exempt portion of capital gains or losses arising in respect of capital property or eligible capital property. We therefore recommend that a Regulation similar to proposed Regulation 5907(2.9), revised as described above, be introduced in order to address this concern.

C. Other matters

There are a number of additional concerns that arise in relation to the proposed fresh start rules. In brief, they include the following:

(i) The proposed concept of "taxable Canadian business" is defined, essentially, as "a business the income from which … is income in respect of which … tax is payable under this Part". This language leaves open the possibility that a business would not be a taxable Canadian business for a taxation year in which it generated losses, or for a year in which no tax was payable because losses from other years were deducted, even if the business was carried on exclusively in Canada and was not a treaty-protected business. We recommend that this concern be addressed by redefining this concept to ensure that a business carried on in Canada, which is not a treaty-protected business, would be regarded as a taxable Canadian business even for years in which it generates losses or uses losses from other years to offset its taxable income.

(ii) Where the "operator" is a partnership, any adjustment or effective adjustment to the cost amount to it of its assets, resulting in an "earnings" or "surplus" consequence to a relevant foreign affiliate, should be matched by an adjustment to the ACB to the affiliate of its partnership interest. While Regulation 5907(12) could be read to provide for such adjustments, it may be preferable for this regulation to be clarified in this respect.

(iii) The reference to "subparagraph (j.1)(iii)" in proposed subparagraph 95(2)(j.2)(i) seems to be inaccurate, and perhaps should be replaced with a reference to "subparagraph (j.1)(v)".

(iv) Whether or not these provisions would apply in the context of a non-resident corporation that becomes a foreign affiliate, because of an acquisition or otherwise, is not entirely clear.

IV. Foreign Exchange Issues

The FA Proposals include a number of amendments intended to address concerns that arise in connection with foreign exchange fluctuations and arrangements entered into by affiliates in order to hedge their exposures in this regard. These amendments are summarized as follows:

(i) Proposed subparagraph 95(2)(a)(vi) applies to include in an affiliate's income from an active business the income or loss derived by it under or as a result of certain agreements hedging paragraph 95(2)(a) active income (corresponding amendments will also be made to the Regulations).

(ii) The definition of "excluded property" is expanded to include new paragraph (c.1), which includes any property arising under or as a result of certain agreements hedging foreign exchange risks on receivables arising on the disposition of excluded property, or in respect of property generating paragraph 95(2)(a) active income.

(iii) Proposed paragraph 95(2)(g.3) deems to be *nil* any income, loss, capital gain or capital loss, derived by an affiliate under or as a result of certain agreements hedging foreign exchange risks arising in respect of property described in paragraph 95(2)(g), and corresponding to income or loss deemed to be *nil* under that paragraph.

(iv) Two new supporting provisions are also introduced. Paragraph 95(2)(h) applies to isolate and allocate foreign exchange gains and losses between excluded property and non-excluded property. Paragraph 95(2)(i) deems any gain or loss of an affiliate to be from the disposition of excluded property determined in accordance with subsection 39(2) if the gain or loss is derived from the settlement or extinguishment of a debt, all or substantially all of the proceeds from which were used at all times to acquire excluded property, or to earn income from an active business, or if the gain or loss is derived under or as a result of an agreement hedging foreign exchange risk, with respect to such a debt.

A. Concerns common to these amendments

Proposed subparagraph 95(2)(a)(vi) applies only in respect of the income or loss derived by an affiliate under or as a result of an agreement that provides for the "purchase, sale or exchange of currency". The same is true of each of the proposals referred to above (except proposed paragraph 95(2)(h)). Thus, it would not apply to foreign exchange and other arrangements structured other than as agreements that provide for the purchase, sale or exchange of currency.

In addition, proposed subparagraph 95(2)(a)(vi) applies only in respect of hedges of receivables, not in respect of hedges of payables. The same is true with respect to the proposals relating to the definition of excluded property. However, the active business income or loss of an affiliate would be determined as a function of both its revenues reflected in receivables and its expenses reflected in payables.

Moreover, as currently drafted, proposed subparagraph 95(2)(a)(vi) refers to an agreement made by an affiliate "to reduce its risk, with respect to an amount …, of fluctuations in the value of the currency in which the amount was denominated". This essentially is true of each of the proposals referred to above (except proposed paragraph 95(2)(h)). This language suggests that the affiliate's risk may arise relative to any other currency, which is appropriate. For example, an affiliate may desire to hedge its exposure to foreign exchange fluctuations between the currency in which a loan it has made is denominated, on the one hand, and the currency in which a loan it has taken out (in order to fund the loan it has made) is denominated, on the other hand. Similarly, a foreign affiliate may, for reasons of corporate policy, desire to hedge its foreign exchange exposure back into Canadian dollars, which would not be inappropriate, given the context of having a relevant taxpayer resident in Canada.

Finally, these proposals would not appear to cover hedging arrangements intended to cover the risk of fluctuations in interest rates (i.e., interest rate swap agreements, etc).

We feel that the proposed amendments should be revised as follows to address these concerns.

(i) The scope of these provisions should be broader to encompass other types of hedging arrangements, which may not be structured in the form of agreements that provide for the purchase, sale or exchange of currency, using language along the lines of that in paragraph 95(2.1)(b).

(ii) The scope of certain of these provisions should be broader to also encompass hedging arrangements which relate to foreign exchange risk to which an affiliate is exposed in respect of payables which are relevant in computing its income or loss from an active business.[15]

(iii) The language of these provisions could be clarified as follows:

> "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*".

[15] For example, proposed subparagraph 95(2)(a)(vi) should be changed to read, in part, "….with respect to an amount required by this paragraph to be included *or deducted* in computing….."

(iv) The language of these provisions, where relevant, should be expanded to include the following:

> "*risk … of fluctuations in the rate at which interest is calculated in respect of an obligation*".

B. Hedging active income streams

As noted above, proposed subparagraph 95(2)(a)(vi) applies to include in an affiliate's income from an active business the income or loss derived by it under or as a result of an agreement that provides for the purchase, sale or exchange of currency and that can reasonably be considered to have been made by the affiliate to reduce its risk relating to foreign exchange fluctuations with respect to amounts required to be included in computing its income or loss from an active business under paragraph 95(2)(a).

Proposed clause (d)(ii)(L) of the definition of "exempt earnings" in Regulation 5907(1) includes in an affiliate's exempt earnings all income described in subparagraph 95(2)(a)(vi), regardless of whether the corresponding paragraph 95(2)(a) active income would be included in its exempt or taxable earnings.

We believe that this Regulation should be refined so as to exclude amounts that may reasonably be considered to relate to hedges of taxable earnings. Such an exclusion could be crafted by rewording this provision as follows:

> "amounts required to be included in computing the particular affiliate's income for the year from an active business because of subparagraph 95(2)(a)(v) or (vi) *to the extent that such amounts can reasonably be considered to relate to amounts which are included or deducted in computing the particular affiliate's exempt earnings or exempt loss in respect of the corporation*".[16]

C. Hedges and the definition of excluded property

Proposed paragraph (c.1) of the definition of "excluded property" in subsection 95(1) includes any property arising under or as a result of a written agreement that provides for the purchase, sale or exchange of currency, and can reasonably be considered to have been made by an affiliate to reduce its risk of fluctuations in the value of the currency in which an amount receivable was denominated, where the amount was receivable under a written agreement that relates to the sale of excluded property or the amount receivable was a property described in paragraph (c) of the definition of "excluded property".

[16] A corresponding change would also be required in the wording of proposed clause (c)(ii)(L) of the definition of "exempt loss" in Regulation 5907(1).

We feel that the proposed amendments in this area should be revised to address the following concerns.

(i) This provision should address a similar concern to the one described above. That is, where an affiliate has sold excluded property, a foreign exchange fluctuation that reduces the value of the resulting receivable would give rise to a corresponding entitlement under a hedge of that receivable. Absent this provision, the affiliate may realize a FAPI gain on closing out its position under that hedge.

(ii) It is not clear to us why it is necessary for an amount receivable arising from a sale of excluded property to be documented by a written agreement in order for a related hedge to qualify for the treatment afforded by this provision. We feel that the reference to "a written agreement that relates to the sale of excluded property" be replaced with a reference to "*an agreement* that relates to the [purchase or] sale of excluded property". In addition, we feel that it is appropriate for the definition of excluded property be expanded to make it clear that where, to reduce its foreign currency risk in respect of an excluded property or in respect of gains/losses on loans that are deemed to be gains/losses of excluded property, a foreign affiliate enters into a hedge with another foreign affiliate in which the taxpayer has a qualifying interest, the hedge would be excluded property to the other affiliate.

(iii) It is also unclear what the second type of amount is to which this provision would relate. Proposed subparagraph (c.1)(ii) of the definition of "excluded property" refers to property arising under or as a result of a written agreement made by the affiliate to reduce its risk "with respect to … an amount that was receivable and was a property described in paragraph (c)". The related Explanatory Notes are silent on the point.

Arguably, some provision should be made for the value of positions under hedges of income streams from property described in paragraph (c) of the definition of "excluded property" (i.e., hedges described in proposed subparagraph 95(2)(a)(vi)), and this may be what this language alludes to. On the other hand, property arising under or as a result of such hedges may already be excluded property under paragraph (c), because all income received from that property would be included in active business income under proposed subparagraph 95(2)(a)(vi).

Moreover, some provision should also be made with respect to the value of positions under hedges of the capital element of property other than receivables described in paragraph (c), for example hedges relating to excluded property that is intangible property.

We therefore recommend that this provision be clarified so as to refer to an agreement made by the affiliate to reduce its risk with respect to:

- an amount that was, or that could reasonably be expected to become, receivable in respect of a property described in paragraph (c);
- an amount reflecting the value, determined in a foreign currency, of a property described in paragraph (c);
- an amount that was, or that could reasonably be expected to become, payable and that could reasonably be considered to be deductible in computing the affiliate's income from an active business in accordance with paragraph 95(2)(a); and,
- an amount that was, or that could reasonably be expected to become, receivable or payable, as the case may be, in respect of the disposition or acquisition, as the case may be, of excluded property.

D. Isolating and allocating foreign exchange fluctuations

As noted above, two new supporting provisions apply to isolate and allocate foreign exchange fluctuations between excluded property and non-excluded property. Proposed paragraph 95(2)(h) applies to provide that, in applying subsection 39(2) for the purpose of subdivision i, the gains and losses of a foreign affiliate of a taxpayer in respect of excluded property must be computed in respect of the taxpayer separately from the gains and losses of the affiliate in respect of property that is not excluded property. This measure is appropriate because subsection 39(2) aggregates all foreign exchange gains and losses realized in a particular year and then deems a capital gain or loss only to the extent of any net gain or loss, without regard to the source of particular gains and losses.

In addition, proposed paragraph 95(2)(i) applies to achieve two allocation functions. First, subparagraph 95(2)(i)(i) would deem any gain or loss of an affiliate, determined in accordance with subsection 39(2), to be a gain or loss, as the case may be, from the disposition of an excluded property if the gain or loss is derived from the settlement or extinguishment of a debt, all or substantially all of the proceeds from which were used at all times to acquire excluded property or to earn income from an active business or for a combination of those uses.

This proposed amendment expands the scope of current paragraph 95(2)(i) in certain respects. The current rule requires the indebtedness to have related at all times to the acquisition of excluded property. Thus, there is no "all or substantially all" threshold, so minor "misuses" disqualify the entire debt. Moreover, the current rule does not apply to debt used to finance obligations arising in the course of an active business, other than with respect to the acquisition of excluded property, such as debt used to finance payments for services.

Similarly, subparagraph 95(2)(i)(ii) deems any gain or loss of an affiliate determined in accordance with subsection 39(2) to be a gain or loss, as the case may be, from the disposition of an excluded property if the gain or loss is derived under or as a result of an agreement that provides for the purchase, sale or exchange of currency, and that can reasonably be considered to have been made by the affiliate to reduce its risk, with respect to a debt referred to in subparagraph (i), of fluctuations in the value of the currency in which the debt was denominated. Accordingly, both foreign exchange gains and losses derived from the settlement or extinguishment of a qualifying debt and any such gains or losses under or as a result of a related hedge, will be deemed to be from the disposition of an excluded property. Therefore, the amount of any such gains or losses would generally have to be computed in the calculating currency of the relevant affiliate, pursuant to subparagraph 95(2)(f)(ii).

We are concerned that, as currently drafted, this provision would be too narrow. In particular, we are concerned that the reference to subsection 39(2) may not be appropriate in the context of a gain or loss arising in respect of a hedge, particularly where the hedge is structured as an agreement which provides for the purchase of currency. In that context, the relevant taxpayer's gain may well be a gain which arises under subsection 39(1), on the basis that the taxpayer's cost of the currency will be determined as a function of consideration given for that currency under the agreement (i.e., the spot price for the currency in which payment is made by the taxpayer) and the taxpayer could then have a gain or loss on the subsequent disposition of that currency, depending on its fair market value at the time of disposition relative to that cost.

In addition, proposed subparagraph 95(2)(i)(i), as currently drafted, applies only where the "proceeds" of the relevant debt were "used" for certain purposes. This language could be interpreted to exclude a balance of sale arising in respect of the acquisition of excluded property or in respect of expenditures made or incurred for the purpose of earning income from an active business, and debt which was assumed in connection with the acquisition of excluded property. We assume that such an exclusion is not intended.

We therefore recommend that this proposed provision be modified in the following respects:

- the reference to subsection 39(2) should be deleted; and,
- both loans and other debts should clearly be covered.

E. Computing gains, losses, and income or loss from property

As noted above, paragraph 95(2)(f) provides for the currency in which certain gains and losses are to be computed. It is proposed that this paragraph be amended to add reference to capital gains and capital losses (in addition to taxable capital gains and allowable capital losses), to add reference to gains and losses from the disposition of property by a partnership, and to add reference to the relevant taxpayer. Arguably, each of these references would simply result in greater clarity, with the possible exception of the addition of the reference to property owned by a partnership in the midamble.

In addition, new paragraph 95(2)(f.1) provides that the income or loss from property of a foreign affiliate must be computed in Canadian currency. This provision would also require the income or loss from property of a foreign affiliate to be computed in accordance with Part I of the Act as though the affiliate were resident in Canada.

The effect of proposed paragraph 95(2)(f.1) is not entirely clear. For example, it is not clear whether this provision would render section 17 applicable in respect of an interest-free loan by one foreign affiliate to another. Similarly, it is not clear whether this provision would render section 91 applicable.

We submit that the scope of this provision should be modified by specifically excluding the application of provisions of the Act that from a tax policy perspective should not be applicable in the context of computing the income from property of a foreign affiliate. We have identified the following provisions that we submit should be specifically excluded – namely, section 17, subsection 18(4), section 91 and subsection 80(13). We note, however, that our review of the Act for this purpose has not been comprehensive and, therefore, that this enumeration may not be complete.

Further, proposed paragraph 95(2)(f.1) is intended to apply to taxation years that begin after the announcement date. Because there may be some non-resident trusts that are now caught by new section 94, where such trusts own shares of a foreign holding company, that holding company will become a foreign affiliate and a CFA when the trust is deemed resident on January 1, 2003. If the holding company has a non-calendar year end, new paragraph 95(2)(f.1) would not be applicable to the first year that it is a CFA. Accordingly, we submit that paragraph 95(2)(f.1) should apply to years that end after the announcement date.

Proposed paragraph 95(2)(f.1) also seems to be too narrow in certain respects. In particular, this provision should also deal with accrued debt-forgiveness, and accrued income from a business other than an active business (i.e., 95(2)(a.1) to (b)). Moreover, in this respect, the application of proposed paragraph 95(2)(f.1) should be coordinated with the application of proposed paragraphs 95(2)(k) to (k.3). That is, whether or not these provisions would apply in the context of a non-resident corporation that becomes a foreign affiliate, because of an acquisition or otherwise, is not entirely clear.

F. Recommendations for the stop-loss rule in subsection 93(2)

We note that one of the measures described in an earlier comfort letter from the Department of Finance[17] was not introduced with the FA Proposals. This is the measure that would limit the application of the stop-loss rule in subsection 93(2) where the loss relates to a foreign exchange fluctuation rather than to the receipt of "exempt dividends".

Subsection 93(2) is a stop-loss rule that in certain respects, at least superficially, resembles the domestic stop-loss rule in subsection 112(3). However, on closer analysis, it is apparent that the effect of these two rules is radically different in practice.

In the domestic context, in the absence of subsection 112(3), it would be possible for a corporation to artificially manufacture a loss by incorporating and capitalizing a wholly-owned subsidiary, then causing the subsidiary to pay a dividend in the amount received by it on such capitalization, then disposing of the shares of the subsidiary in a transaction to which none of the loss suspension rules would apply. The reason why this would be possible in the domestic context is because domestic dividends do not reduce the shareholder's ACB of the relevant shares.

In contrast, in the foreign affiliate context, a dividend which exceeds exempt and taxable surplus will be treated as having been paid out of the affiliate's pre-acquisition surplus, and will result in a corresponding reduction of the taxpayer's ACB of the relevant shares.[18] Thus, it would not be possible for a corporation to artificially manufacture a loss in the manner described above. Moreover, from a tax policy perspective, there seems to be no reason to reduce a loss by the amount of any dividends paid out of the relevant affiliate's exempt surplus or fully-taxed taxable surplus. This proposition becomes evident in light of the following analogy.

Essentially, subsection 112(3) is intended to perform the same function as that performed by subsection 55(2). That is, both rules are intended to prevent the manipulation of capital gains and losses through the payment of dividends. Subsection 55(2) applies to certain dividends that *reduce capital gains*. Subsection 112(3) applies to certain dividends that *increase capital losses*. From a tax policy perspective, there seems to be no difference between artificially reducing a gain, and artificially increasing a loss, through the payment of dividends. Both have exactly the same effect.

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[17] See the letter dated February 12, 2001, issued to Angelo Nikolakakis.

[18] See paragraph 113(1)(d) and subsection 92(2).

Interestingly, subsection 55(2) permits the reduction of gains to the extent of the relevant corporation's "safe income".[19] Arguably, therefore, from a tax policy perspective, subsection 112(3) should also permit losses to the extent that the relevant prior dividends were paid out of safe income. For whatever reason, however, subsection 112(3) does not have such a limitation. Instead, there is another limitation, set out in subsection 112(3.1), which permits losses to the extent that the relevant prior dividends were paid at a time when the relevant taxpayer(s) held no more than 5% of the relevant corporation, provided that the shares in question are held for at least one year prior to the disposition giving rise to the loss. This is simply a different mechanism to achieve the same result – namely, to permit the recognition of real economic losses, on the basis that the payment of ordinary course dividends and dividends paid out of underlying earnings (i.e., safe income) does not represent or result in an artificial inflation of losses or in an artificial increase of gains. Indeed, so analogous is the concept of safe income to the concepts of exempt surplus and fully-taxed taxable surplus in this respect that safe income is specifically defined to include exempt surplus and fully-taxed taxable surplus.[20]

Accordingly, on the basis that the foreign affiliate rules simply do not lend themselves to the type of manipulation which could, in the absence of rules such as subsections 55(2) and 112(3), result in the artificial reduction of gains or the artificial increase of losses, it is submitted that subsection 93(2) should be repealed or substantially restricted. This would fully address the concerns that have been raised with respect to the inappropriate denial of losses arising because of underlying foreign exchange fluctuations. We submit that this provision should be restricted (rather than being repealed) only as a means of addressing surplus continuity concerns such as those expressed Section I.

[19] See the definition of "safe-income determination time" in subsection 55(1).

[20] See paragraph 55(5)(d). The analogy between safe income and exempt dividends from a foreign affiliate was also recognized by the CCRA in a Technical Interpretation dated December 9, 1996 (9611945).

V. Financing Foreign Affiliates

Paragraph 95(2)(a) is critical in determining the tax consequences of a variety of inter-affiliate financing transactions and similar arrangements. The FA Proposals amend this provision in a number of ways.

A. Qualifying Members of a Partnership

The FA Proposals include a global change to paragraph 95(2)(a) that replaces references to members of a partnership other than "specified members" with references to "qualifying members" of a partnership. Whereas the "specified member" concept was drawn from the "at-risk" rules, and would include a limited partner, the "qualifying member" concept was introduced in order to facilitate the use of limited partnerships in foreign affiliate arrangements.

A "qualifying member" of a partnership is defined in new paragraph 95(2)(o). This definition describes a member of the partnership that satisfies certain alternative conditions at a particular time – namely, either:

(i) that throughout the period, in the fiscal period of the partnership that includes the particular time, during which the member was a member of the partnership, the particular person is, on a regular, continuous and substantial basis, actively engaged in those activities, of the principal business of the partnership carried on in that fiscal period by the partnership, that are other than activities connected with the provision of or the acquisition of funds required for the operation of that principal business, or actively engaged in those activities, of a particular business carried on in that fiscal period by the particular person (otherwise than as a member of a partnership) that is similar to the principal business carried on in that fiscal period by the partnership, that are other than activities connected with the provision of or the acquisition of funds required for the operation of the particular business; or

(ii) that throughout the period, in the fiscal period of the partnership that includes the particular time, during which the member was a member of the partnership, the total of the fair market value of all partnership interests in the partnership owned by the particular person was equal to or greater than 1% of the total of the fair market value of all partnership interests in the partnership owned by all members of the partnership, and the total of the fair market value of all partnership interests in the partnership owned by the particular person or persons (other than trusts) related to the particular person was equal to or greater than 10% of the total of the fair market value of all partnership interests in the partnership owned by all members of the partnership.

Thus, a foreign affiliate can be a qualifying member of a partnership, even if it is a limited partner, provided that it holds not less than a 1% interest individually and not less than a 10% interest together with related persons (other than trusts).

This change appears in paragraph 95(2)(a) in the following provisions – subclauses (a)(ii)(A)(II) and (a)(ii)(B)(II), and clause (a)(ii)(C). Each of these provisions relates to the treatment of payments made by a partnership. As noted below, the qualifying member concept is relevant also for purposes of the definition of "investment business" in subsection 95(1).

Inconsistency in ownership thresholds

There remains an inconsistency between the ownership threshold required for foreign affiliate status and that required for qualifying member status, in that foreign affiliate status can be achieved where the relevant Canadian taxpayer holds a 1% equity percentage (directly or indirectly), so a particular affiliate of the taxpayer may directly hold less than 1% of another affiliate of the taxpayer, but not less than 1% of a partnership, unless it is actively engaged in qualifying business activities of the partnership or of its own.[21]

It is not clear why the 1% direct ownership threshold is necessary. Because of the 10% threshold, this provision would necessarily apply only in circumstances where an interest of at least l0% in the partnership is held within the relevant related group. In circumstances involving such a significant within-group ownership level in the corporate context, every related member of the corporate group would have a qualifying interest in respect of the relevant non-resident corporation.[22] Moreover, it is quite often the case that, in the context of a wholly owned partnership (i.e., where 100% of the interests are held by members of the same group), one of the members (generally, but not necessarily, the general partner) may hold less than a 1% interest, because of perfectly legitimate business reasons. It seems difficult to understand why such a member should not be a qualifying member of such a partnership.

Therefore, it is submitted that this definition be modified to include *any member* of the partnership where an aggregate interest of not less than 10% in the partnership is held by the member either alone or together with related persons.

[21] It should be noted that proposed paragraph 95(2)(q) would for these purposes deem partnership interests or shares held by a partnership or a non-discretionary trust to be held by the members or beneficiaries in proportion to the relative fair market values of their interests. However, this provision would not deem shares or partnership interests held by a corporation to be held by the corporation's shareholders.

[22] See proposed paragraph 95(2)(n).

Financing partnerships

As noted above, proposed clauses 95(2)(o)(i)(A) and (B) exclude from qualifying member status a partner that is, on a regular, continuous and substantial basis, actively engaged in those activities of the principal business of the partnership that are connected with the provision of or the acquisition of funds required for the operation of that principal business. This exclusion seems inappropriate in the context of a partnership that carries on an investment business or other financing-type activity, in which the provision of or the acquisition of funds required for the operation of that business would be an integral part of the business. Therefore, it is submitted that this exclusion be eliminated, such that proposed clauses 95(2)(o)(i)(A) and (B) would read as follows:

> (A) actively engaged in *the* activities of the principal business of the partnership carried on in that fiscal period by the partnership, *including* activities connected with the provision of or the acquisition of funds required for the operation of that principal business, or
>
> (B) actively engaged in *the* activities of a particular business carried on in that fiscal period by the particular person (otherwise than as a member of a partnership) that is similar to the principal business carried on in that fiscal period by the partnership, *including* activities connected with the provision of or the acquisition of funds required for the operation of the particular business, or

Timing of "qualifying member" test

In addition, we note that the "qualifying member" test applicable under proposed subclauses 95(2)(a)(ii)(A)(II) and (B)(II), proposed clause 95(2)(a)(ii)(C), and corresponding Regulations, must be met throughout the relevant taxation year. Arguably, it seems appropriate to introduce a supporting provision like that in subsection 95(2.2) in order to address circumstances in which an entity has become a qualifying member of a partnership part way through a taxation year as a result of a relevant acquisition or disposition.

Statutory assumptions needed in order to benefit from paragraph 95(2)(a)

Many of the rules in paragraph 95(2)(a) apply to payments made by certain partnerships or corporations that are technically not foreign affiliates of the relevant taxpayer, provided that certain conditions are met. For example, proposed subclause 95(2)(a)(ii)(A)(II) is applicable to payments made by a partnership of which a related non-resident corporation is a qualifying member. One of the conditions that must be met for this rule to apply is that the "amounts … would, if the … partnership were a foreign affiliate of the taxpayer, be deductible by it in the year or a subsequent taxation year in computing the amounts prescribed to be its earnings or loss from an active business".

The problem with this language is that the statutory assumption falls short of the requirement that must be met by a foreign affiliate in order for it to benefit from paragraph 95(2)(a). In other words, even if the partnership were a foreign affiliate of the taxpayer, it is not clear that the partnership would be entitled to rely on paragraph 95(2)(a) in computing its active business income, because the statutory assumption does not require this analysis to be carried out on the basis that the partnership not only would be a foreign affiliate but also would be one in which the relevant taxpayer had a qualifying interest. Thus, it is not clear that payments made by the partnership to an affiliate would be deductible in computing the partnership's active business income if the partnership's only source of revenues was payments from another affiliate of the taxpayer to which 95(2)(a)(ii) would apply if the partnership were a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest.

Accordingly, we recommend that this statutory assumption be modified to better accord with the requirements of paragraph 95(2)(a). Essentially, we feel that the reference to "were a foreign affiliate of the taxpayer" should be replaced with a reference to "were a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest throughout the year". This reference appears in the following provisions: proposed subclauses 95(2)(a)(ii)(A)(II) and (B)(II), proposed clause 95(2)(a)(ii)(C), and corresponding Regulations.

The same applies to proposed clause 95(2)(a)(ii)(C), which refers to "computing the amounts prescribed to be its earnings or loss from an active business carried on by it outside Canada". This language is inconsistent with the language in proposed clauses 95(2)(a)(ii)(A) and (B), which refer to "computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada". Arguably, the latter formulation would also be more appropriate in the context of proposed clause 95(2)(a)(ii)(C), and we therefore recommend that the language in proposed clause 95(2)(a)(ii)(C), and corresponding Regulations, be revised accordingly.

Additional references to partnerships

We believe that there are other rules in proposed paragraph 95(2)(a) which could be improved by adding appropriate references to partnerships. In particular, we recommend adding such references to proposed subparagraph 95(2)(a)(i), proposed clause 95(2)(a)(ii)(D), and proposed subparagraphs 95(2)(a)(iii) and (iv).

In addition, there are other paragraphs in subsection 95(2) that do not refer to partnerships at all (for example, 95(2)(i), (g) and (g.3)). From a tax policy perspective, there appears to be no reason why the relief from FAPI contemplated in those provisions should not apply to partnerships where a foreign affiliate is a qualified member of the partnership. We suggest that such provisions be clarified accordingly.

There also appear to be certain other rules that are not consistent. For example, whereas subparagraph 95(2)(a)(ii) applies to amounts paid or payable "directly or indirectly", there is no clear equivalent to the "directly or indirectly" standard in the context of paragraph 95(2)(g). We therefore recommend that such wording be added to paragraph 95(2)(g), and that a review be conducted to ensure that the relevant inter-related rules are consistent.

B. Acquisition financing

General concerns in clause 95(2)(a)(ii)(D)

The rule in clause 95(2)(a)(ii)(D), which is intended to facilitate certain types of foreign affiliate acquisition financing arrangements, has often been very difficult to apply, in part because of its restrictive nature. Under the current language, the shares of each member of the relevant corporate group must be excluded property and each such member must be resident and subject to income taxation in the same country. Thus, for example, if the group includes a dormant corporation, the shares of which do not constitute excluded property, the group is disqualified. Similarly, a group can be disqualified if it includes an entity such as an LLC, which is not subject to tax in the relevant country because it is disregarded. Moreover, the current language has no *de minimis* threshold. Finally, the provision does not apply in cases where the "second" and "third" affiliate are foreign affiliates of a Canadian corporation which is related to the "taxpayer" in respect of the lending affiliate.[23]

Accordingly, we suggest that these concerns be addressed by substituting an aggregate income (and loss) test for the existing entity-level excluded property test. That is, proposed subclause 95(2)(a)(ii)(D)(VI) should require that it be "reasonable to conclude that all or substantially all of the amount that is the total of all amounts each of which is the income, or the absolute value of the loss, of a group member, from a source, for a taxation year of that group member that ends in the year is attributable to incomes and losses from an active business". In this way, a *de minimis* threshold is introduced. In addition, shares of dormant group members would be irrelevant.

However, a new concern arises from this new language, in that it would inappropriately disqualify a group if its substantial active business operations generated no profit or loss in a particular period, but some *de minimis* passive operations generated either a profit or a loss. Similarly, depending on how the word "income" in this language is interpreted, a group with only active business income in its operating companies could be disqualified, if operating companies pay their profits up to intermediary holding companies, since the dividends received by these holding companies will generate income other than active business income. Arguably, neither group should be disqualified. Finally, the all or substantially all test may not be met if interest expense

[23] This issue will be corrected with proposed paragraph 95(2)(n).

incurred by the second affiliate is substantial relative to the active business income generated by the group.

Concerns in subclauses 95(2)(a)(ii)(D)(V) and (VI)

With respect to accommodating disregarded group members, it is proposed that new subclause 95(2)(a)(ii)(D)(V) set out two alternative tests. The first is that each relevant affiliate must be "subject to income taxation in that country in that relevant taxation year". The second test, for disregarded group members, is that the "members or shareholders" of each relevant affiliate at the end of that relevant taxation year must be "subject to income taxation" in that country on, in aggregate, all or substantially all of the income of the disregarded affiliate for that relevant taxation year in their taxation years in which that relevant taxation year ends or "would be so subject to income taxation" in that country if that disregarded affiliate had income for that relevant taxation year and the income of those members or shareholders for their taxation years in which that relevant taxation year ends consisted only of their share of income of that disregarded affiliate for that relevant taxation year.

This language is helpful, but a number of concerns would still arise. First, this language does not accommodate a group in which the shares of one disregarded affiliate were held by another disregarded affiliate, since the members or shareholders of the bottom disregarded affiliate would not be subject to income taxation on its income. Moreover, the reference to members or shareholders who "would be so subject to income taxation" in sub-subclause 95(2)(a)(ii)(D)(V)(2) causes concern with respect to the interpretation of the reference to "is subject to income taxation" in sub-subclause 95(2)(a)(ii)(D)(V)(1). That is, if the "would be subject to" language in sub-subclause 95(2)(a)(ii)(D)(V)(2) is necessary to deal with circumstances in which there is a loss (or no profit or loss), then the absence of this language in sub-subclause 95(2)(a)(ii)(D)(V)(1) is cause for concern, particularly since proposed subclause 95(2)(a)(ii)(D)(VI) would make reference only to amounts relevant in computing the "income" (not the "income or loss") of relevant entities.

In addition, proposed sub-subclause 95(2)(a)(ii)(D)(VI)(2) accommodates circumstances in which the "second affiliate" (i.e., the one making interest payments to the "first affiliate") used the proceeds of the loan to acquire shares of a disregarded entity (which would be the "third affiliate"), provided that the interest payments are relevant in computing the "income" of the second affiliate and certain other conditions are met, such that all or substantially all of the income or loss of the third affiliate is from an active business.

Concerns in corresponding Regulations

With respect to the proposed changes in Regulation 5907(1), being clause (d)(ii)(H) of the definition of "exempt earnings" and (c)(ii)(H) of the definition of "exempt loss", a number of additional concerns arise.

First, sub-subclauses (H)(II)(1) and (2) refer to income or losses from "an active business carried on in a designated treaty country". This suggests that inter-affiliate or other income included in active business income pursuant to paragraph 95(2)(a) would not qualify, even if it arises in a designated treaty country, unless the reference to "attributable to" permits such income to qualify, given that these sub-subclauses do not refer to an active business carried on "by the affiliate". In contrast, proposed sub-subclauses 95(2)(a)(ii)(D)(VI)(1) and (2) would seem to accommodate such inter-affiliate or other income.

Additionally, the definition of "excluded property" is modified for purposes of these Regulations, such that it includes property which does or would generate active business income under paragraph 95(2)(a) only if such income is or would be derived from amounts paid or payable by "payors who are entitled to deduct the amounts in computing their exempt earnings or exempt loss". This language does not appear to properly accommodate property which gives rise to active business income under subparagraph 95(2)(a)(i), or clause 95(2)(a)(ii)(A), to the extent that such income arises from amounts paid or payable by non-affiliates. This is because it seems difficult to conclude that such non-affiliates "are entitled" to deduct such amounts in computing their exempt earnings or loss.[24] Arguably, a better formulation of this language would be to simply require that the income be included in computing the exempt earnings or loss of the payee, rather that derived from payments which are deductible in computing the exempt earnings of the payor.

Recommendations for the reformulation of clause 95(2)(a)(ii)(D)

The above and other continuing concerns with respect to the formulation of clause 95(2)(a)(ii)(D) have led us to revisit the more basic issues that it must address. In this regard, we understand that this provision was intended to overcome what is essentially a technical issue, not really a tax policy issue. That is, where a particular foreign affiliate is a holding company, in the sense that it holds shares of another affiliate (the "acquired affiliate"), and it incurs interest expense in connection with the shares of the acquired affiliate, that expense is generally considered to be incurred for the purpose of earning income from those shares – and would result in a passive loss, but for the specific exclusions in the descriptions of A and D of the definition of FAPI.[25]

[24] On the other hand, there may be an argument that the income could qualify even where the payor is a foreign affiliate of a completely unrelated taxpayer, since payments could be deductible in computing its exempt earnings or loss albeit in respect of another taxpayer. This is probably not the intended interpretation, given that separate calculations are generally made in respect of each taxpayer.

[25] Because of these exclusions, and because of the proposed expansion of paragraph 95(2)(b), there is no risk that such interest expense would be used to reduce FAPI.

Thus, even if the relevant foreign tax law permits (or requires) the interest expense to be deducted in computing income from some other source (i.e., where the particular affiliate also carries on an active business directly, and the foreign tax law apportions interest expense to that source), this interest might not qualify as active business income to the recipient under paragraph 95(2)(a)(ii)(A) or (B).[26] A similar issue arises where the relevant foreign tax law permits the interest expense to be (effectively) deducted against income from another source (i.e., an indirectly-held active business) because it provides for consolidated filing or group relief. In both contexts, foreign tax law treats the interest expense differently from its treatment under Canadian tax law.

What is important to note here is that the presence of tax consolidation principles under a relevant foreign tax law is simply one of several circumstances in which foreign tax law treats interest expense differently from its treatment under Canadian tax law. The presence of interest apportionment rules is another such circumstance. The presence of entity classification principles or specific deeming rules that disregard corporate entities is yet another such circumstance. In either case, the interest expense results in relevant deductions under foreign tax law. Even where the foreign tax law treats interest expense in the same manner as its treatment under Canadian tax law, in the sense that it considers it deductible in computing the affiliate's income from the shares, those deductions remain relevant from the perspective of the relevant taxpayer, to the extent that dividends from those shares would otherwise be taxable under the foreign tax law. Although Canada generally does not tax inter-company dividends, certain other countries do, so it remains relevant to use interest expense to reduce foreign tax on those dividends. Moreover, certain foreign countries do not impose capital tax on indebtedness or withholding tax on interest expense, so it remains relevant to use indebtedness and interest expense where equity capital or dividends would result in adverse foreign tax consequences.

From a Canadian perspective, to the extent that the shares of the acquired affiliate are excluded property, the interest expense of the particular affiliate should be regarded as being attributable to an indirectly-held active business, and therefore should be included in computing the active business income of the recipient affiliate. The treatment of the interest expense under foreign tax law is simply not the material consideration from a Canadian perspective in the context of clause 95(2)(a)(ii)(D), just like the treatment of the interest expense under foreign tax law is simply not the material consideration in the context of clause 95(2)(a)(ii)(B).[27]

[26] See Regulation 5907(2)(c).

[27] See Regulation 5907(2)(j).

Moreover, the peculiarities of a particular jurisdiction's tax consolidation rules may render clause 95(2)(a)(ii)(D) inapplicable. For example, in Technical Interpretation #1999-0009685, the CCRA considered a circumstance in which Finco, a wholly owned foreign affiliate of Canco, loans funds to FA1, a wholly owned foreign affiliate of Canco resident in the UK. FA1 uses the borrowed funds to acquire all of the shares of FA2, another company resident in the UK. FA1 and FA2 are the only UK affiliates of Canco. FA1 has no revenue but it pays interest of $10,000 on its debt to Finco. FA2 has net income from its active business operations of $7,000. In computing their income for tax purposes, FA1 surrenders $7,000 of its loss to FA2, which uses the loss to reduce its taxable income for UK tax purposes to nil. Under UK tax law, the remaining $3,000 of the loss incurred by FA1 cannot be surrendered to FA2 because FA2 cannot use such portion of the loss in that taxation year. The remaining loss will be available for carryforward for use only by FA1 in future taxation years because a loss carryforward is not eligible for group relief. FA1 is unable to claim the loss carryforward in computing its UK tax liability in any taxation year.

In this situation, it is the CCRA's position that only $7,000 of the interest would be relevant in computing the liability for income taxes in that country of the members of a group of corporations for the purposes of subclause (V). Therefore, only $7,000 of the interest income would be included in the income from an active business of Finco. The remainder would remain income from property and be included in the FAPI computation of Finco. Significantly, if FA1 and FA2 were resident in the US, they would form a consolidated group for US tax purposes and clause 95(2)(a)(ii)(D) would be applicable, assuming the other conditions are met. It is not evident how or why the foreign tax consequences or, in this situation, why being subject to the US tax consolidation system, versus the UK group loss transfer system, should be relevant for purposes of determining whether interest paid to Finco is FAPI.

Thus, the treatment of the interest expense under foreign tax law should not be a condition for the treatment of the interest expense for Canadian tax purposes – that is, it should not be a condition for the application of clause 95(2)(a)(ii)(D). Taxpayers will structure their affairs in such ways as to render the interest expense relevant under foreign tax law, and should be permitted to do so from a Canadian perspective.

That said, the fact that the interest expense is not directly deductible in computing an affiliate's active business income gives rise to certain surplus computation concerns. Regulation 5907(2.8) addresses this concern in part, by providing for a blocking deficit that should offset surplus resulting from active business income computed before interest expense. However, we recognize that this provision alone may not be sufficient to address all of the concerns that arise in such circumstances. That is, it may be possible for a taxpayer to eliminate this blocking deficit.

The elimination of blocking deficits is a more general concern, which arises in a variety of circumstances. Indeed, the elimination of blocking deficits is a concern even in the context of clause 95(2)(a)(ii)(D) as currently formulated, notwithstanding that it currently has a consolidated group requirement. However, the FA Proposals address this concern by reformulating Regulation 5905(7), to preserve blocking deficits upon the liquidation of foreign affiliates. Furthermore, we have described a number of additional measures in Section I that could be introduced in order to address surplus computation concerns more comprehensively.

Finally, it should be acknowledged that these concerns should generally only be relevant in circumstances where the borrowing affiliate is a holding company that has no other sources of income or has losses. Many such affiliates will have sources of income to offset the cost of borrowing to acquire the shares, such as dividend payments from the third affiliate and from other investments in order to finance interest payments to the lending affiliate. In other words, not all borrowing affiliates will necessarily generate deficits as a result of the borrowing to acquire shares of another affiliate.

Accordingly, we submit that the reformulation of Regulation 5905(7) paves the way for the reformulation of clause 95(2)(a)(ii)(D), such that it should apply in any case where, from a Canadian perspective, the interest expense is considered attributable to an indirectly-held active business – that is, in any case where the interest expense is considered to have been incurred by a particular affiliate for the purpose of earning income from shares of an acquired affiliate where those shares are excluded property. We therefore propose the following recommendations for the reformulation of clause 95(2)(a)(ii)(D).

(i) Proposed subclause (VI) should be deleted and the requirement that the interest expense be relevant in computing the income of a group for income tax purposes in a foreign country should be eliminated.

(ii) Given the concerns regarding "blocking deficits", we understand that Regulation 5907(2.8) may be amended to force the annual netting of any deficit resulting in the "second affiliate" with positive surplus balances remaining in the "third affiliate" (or in any other affiliate in which the third affiliate had an equity percentage).

In this regard, we suggest that the proposed amendments to Regulation 5905(7) and the other recommendations that address surplus computation issues presented in this submission should be sufficient to deal with the elimination of affiliates with "blocking deficits". It is our view, therefore, that additional amendments to the Regulations to deal with this issue will add significant complexity to an already complex area of the Act, and will not provide any material additional protection to the tax base.

(iii) If it is still necessary to enact provisions to deal with any deficit that may arise in the second affiliate, we recommend that Regulation 5907(2.8) and the Act, as appropriate, be amended to include the following provisions:

- To the extent the interest expense incurred by the second affiliate in a particular taxation year with respect to the borrowing to acquire shares of the third affiliate exceeds the surplus account of the second affiliate at the end of the year that would otherwise include the interest deduction, computed without deducting the interest expense for the year, the excess (or, where the relevant surplus account is in a deficit position computed without deducting the interest expense, the interest expense on such borrowing for the year) would be deducted in computing the same surplus account of the third affiliate. This rule would apply for each year or part of a year that the debt that is used to finance the acquisition of the shares of the third affiliate is outstanding.

- To the extent the interest expense incurred by the second affiliate is deducted/added in computing the surplus/deficit of the third affiliate in a particular year, the adjusted cost base of the shares of the third affiliate held by the second affiliate should be increased by the same amount at the end of the year.

- To the extent that the interest expense pushed down to the third affiliate for a particular taxation year as described above exceeds the surplus of the third affiliate at the end of the year, computed without deducting the interest expense for the year, the excess (or, where the relevant surplus account is in a deficit position computed without deducting the interest expense, the entire amount pushed down from the second affiliate) would be deducted in computing the same surplus account of any affiliate of the taxpayer in which the third affiliate has an equity percentage, provided that such affiliate carries on an active business. The taxpayer would be permitted to designate the specific lower-tier affiliate(s) to which such "push-down" would be allocated.

- To the extent that such an amount is deducted by a lower-tier affiliate in computing its surplus accounts as described above, the adjusted cost base of the shares of the affiliate held by third affiliate and by any other affiliate in which the third affiliate has an equity percentage should be increased by the same amount at the end of the year.

The adjustment to surplus and deficit balances of an affiliate as contemplated above would have to take into consideration situations where the taxpayer's surplus entitlement percentage in the affiliate is less than 100%.

(iv) The definitions of "exempt earnings" and "exempt loss" in the corresponding Regulations should also be revised along these lines.

We note, however, that proposed subclauses (H)(III) of these definitions appear to be both too broad and too narrow. On the one hand, they would inappropriately include property described in paragraph (a) of the definition of "excluded property" even if such property is used to derive taxable earnings rather than exempt earnings. On the other hand, they would depend on the relevant exempt earnings arising from amounts paid or payable by other foreign affiliates of the taxpayer (those being the only entities that "are entitled to deduct those amounts in computing their exempt earnings"). This language would inappropriately exclude, for example, payments by partnerships, and amounts to which subparagraphs 95(2)(a)(i), (iii) or (iv) would apply. Thus, we suggest that this provision be reformulated so as to refer to the following modified paragraphs of the definition of "excluded property":

> "(a) used or held by the foreign affiliate principally for the purpose of gaining or producing income from an active business carried on by it, *which income is, or would be if there were such income, included in computing the amount prescribed to be its exempt earnings or exempt loss*"
>
> "(c) property all or substantially all of the income from which *or from the disposition of which* is, or would be, if there was income from *or from the disposition of* the property, income from an active business because of paragraph (2)(a), *which income is, or would be if there were such income, included in computing the amount prescribed to be its exempt earnings or exempt loss*"

We also note that the reference to "paragraph 95(2)(m) or (m.1) of the Act", in proposed subclause (IV) of the corresponding Regulation should be replaced with a reference to "paragraph 95(2)(m) or (n) of the Act".

C. Excluded property on income account

New subparagraph 95(2)(a)(v) includes in an affiliate's income or loss from an active business any income or loss from the disposition of excluded property that is not capital property. This would include, for example, eligible capital property that is used or held in the context of an investment business to earn income from an active business under paragraph 95(2)(a).

Clauses (d)(ii)(L) of the definition of "exempt earnings" and (c)(ii)(L) of the definition of "exempt loss" in Regulation 5907(1) should distinguish between property used or held to earn exempt earnings and property used or held to earn taxable earnings.

D. Qualifying interests

Another important concept in the context of structuring inter-affiliate arrangements is that of "qualifying interest". Only an affiliate in which the relevant taxpayer has a qualifying interest may benefit from the active income inclusion rules in paragraph 95(2)(a), and certain of those rules refer to payor and other relevant affiliates in which the relevant taxpayer has a qualifying interest. This concept is defined in paragraph 95(2)(m).

The FA Proposals include a deeming rule as new paragraph 95(2)(n), which provides that a non-resident corporation will be deemed to be, at any time, "a foreign affiliate of a particular corporation resident in Canada in respect of which the particular corporation has a qualifying interest" if, at that time, the non-resident corporation is a foreign affiliate of another corporation that is resident in Canada and that is related (otherwise than because of a right referred to in paragraph 251(5)(b)) to the particular corporation, and that other corporation has a qualifying interest in respect of the non-resident corporation. Thus, in the context of a related group of Canadian-resident corporations, a non-resident corporation will be deemed to be a foreign affiliate of each member of the group, and each such member will be deemed to have a qualifying interest in the non-resident corporation, if the non-resident corporation is a foreign affiliate of any member of the group which has a qualifying interest in the non-resident corporation.

It should be noted that this rule is not an aggregation rule, so at least one member of the related group must alone have a qualifying interest. That determination must be made in accordance with paragraph 95(2)(m). However, given that paragraph 95(2)(m) has a consolidation rule, which permits shares held by a corporation (or partnership) to be treated as being owned by the corporation's shareholders (or partnership's members), all the shares of a non-resident corporation held in a corporate group would ultimately be deemed to be owned by the parent company, provided that the non-resident corporation was a foreign affiliate of the parent company,[28] so the parent company would have a qualifying interest in the affiliate (assuming enough equity and votes of the non-resident corporation was held within the group), and therefore the affiliate would be deemed to be a foreign affiliate of each related member of the group and each such member would be deemed to have a qualifying interest in the non-resident corporation.

Qualifying interests and individuals

This rule applies only where the taxpayer is a corporation, not where the taxpayer is an individual. This restriction seems inappropriate, given that it is conceivable that two non-resident corporations could be foreign affiliates of the same individual, and that the active business income inclusion rules in paragraph 95(2)(a) are not premised on the assumption that the various non-resident corporations referred to therein are foreign affiliates of (or related to) a Canadian resident corporation.

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[28] It should be noted that the definition of "equity percentage" in subsection 95(4) looks through Canadian resident corporations except for purposes of the definition of "participating percentage".

Therefore, we feel that this provision should be extended so as to deem a non-resident corporation to be a foreign affiliate of a particular *taxpayer* resident in Canada in respect of which the particular *taxpayer* has a qualifying interest if the non-resident corporation is a foreign affiliate of another *taxpayer* that is resident in Canada and that is related (otherwise than because of a right referred to in paragraph 251(5)(b)) to the particular *taxpayer*, and that other *taxpayer* has a qualifying interest in respect of the non-resident corporation.

E. Other matters

The expression "income from property" is defined in subsection 95(1). It would perhaps be appropriate to also define "loss from property" in a corresponding manner.

VI. Excluded Property

A. Paragraph (a) of the definition

The FA Proposals amend paragraph (a) to add a reference to “carried on by it”. A corresponding amendment to paragraph (c) covers most of the property previously covered by paragraph (a) – namely, property of an investment business that is used or held to earn active business income in accordance with paragraph 95(2)(a). However, whereas paragraph (a) applies a test based on the principal purpose or use of an asset, paragraph (c) applies a test based on the “all or substantially all” standard, which seems to narrow the scope of excluded property.

Another context in which the proposals narrow the scope of excluded property is in respect of goodwill and inventory of an investment business which generates active business income in accordance with paragraph 95(2)(a). That is, such property is not used to earn income from an active business carried on by the affiliate, because the affiliate is not deemed by paragraph 95(2)(a) to be carrying on an active business, even though it recharacterizes the income from the business as income from an active business. Thus, such property would not be covered by paragraph (a).

In addition, such property might not be covered by paragraph (c) because the affiliate will generally not, as such, derive any income “from” such property (as opposed to from the disposition of such property, in the case of inventory) and it would appear to be difficult, if not impossible, to apply the “would be” part of the test in the absence of any statutory guidance or assumptions as to how that hypothetical income would be earned. A similar issue does not arise, for example, in the context of a loan, because it would be reasonable to conclude that the hypothetical income from this property would be interest payable by the borrower. However, a similarly reasonable conclusion is difficult to reach in the case of inventory or goodwill.

Accordingly, we submit that the proposed definition of “excluded property” should be revised to address this concern, by introducing a new category of excluded property, which could refer to:

> *(d) goodwill and inventory associated with a business carried on by the affiliate where the fair market value of the property (other than goodwill and inventory) of the affiliate which is excluded property represents all or substantially all of the fair market value of all the property (other than goodwill and inventory) of the affiliate*

B. Paragraph (b) of the definition

Proposed paragraph (b) is amended to refer to the "fair market value" of an affiliate's property. More specifically, the test requires a determination of whether or not all or substantially all of the "fair market value" of an affiliate's property is "attributable to" excluded property.

The reference to "attributable to" gives rise to an interpretive concern. That is, this reference could be interpreted to mean that, in making this determination, the value of the property of an affiliate must be apportioned between excluded property and non-excluded property depending on the underlying asset mix of entities that the affiliate holds interests in.

Consider the following example: FA1 owns FA2. FA2 owns two assets – namely, the shares of FA3 and $9 of non-excluded property. FA3 is worth $91. FA3 also owns two assets – namely, $9 of non-excluded property and $82 of excluded property. In this context, can it be said that more than 90% of the fair market value of FA2's property is "attributable to" excluded property when part of the fair market value of the FA3 shares is ultimately attributable to non-excluded property held by FA3?

Under current rules, the test is applied on a tier-by-tier basis, so that the shares of a particular affiliate are characterized as being excluded property if all or substantially all of its property "is" excluded property. Once that determination is made, those shares represent excluded property in their entirety in the hands of any other affiliate.

We understand that no change to the current rules in this regard was intended. Accordingly, in order to clarify this matter, it is submitted that paragraph (b) of this definition could be reworded as follows:

> *(b) shares of the capital stock of another foreign affiliate of the taxpayer where the fair market value of the property of the other foreign affiliate which is excluded property represents all or substantially all of the fair market value of all the property of the other foreign affiliate*

In addition, the Committee is concerned that the adoption of a continuous fair market value test to characterize the shares of a foreign affiliate is inconsistent with the historical practice adopted by taxpayers and the CCRA allowing the use of a reasonable method not restricted to fair market value, which could be cost or accounting value or some other objectively reasonable basis applied consistently. In particular, we note the concerns expressed about the use of fair market value tests in the context of the foreign investment entity legislation – essentially, that both for taxpayers and tax administrators it is difficult and impractical and potentially disputatious, particularly with illiquid property, to use a test that lacks reliable static reference points.

Accordingly, we recommend that, instead of the proposed fair market value determination, a "snapshot" approach be adopted that would allow taxpayers to select, for consistent application during a stated period (say five years), a reasonable method for determining whether shares of a foreign affiliate are excluded property. These might be any of, for example, fair market value at the acquisition date of property, accounting value as reflected on the financial statements, acquisition cost or other similarly reliable determinants.

We are concerned that, in making necessary excluded property determinations in the normal application of the foreign affiliate rules, valuations would be required which, in any event, would not be immune from disagreement by the CCRA with no reliable point of reference to resolve such a disagreement. In addition, in the context of proposed clause 95(2)(a)(ii)(D), such valuations of the underlying assets of the third affiliate could be required either on a daily basis or at every time that interest is paid by the second affiliate, depending on how the relevant language in this provision is interpreted.

C. Paragraph (c) of the definition

It is not clear why the reference in paragraph (c) to “if that paragraph were read without reference to subparagraph (2)(a)(v)” is necessary. Proposed subparagraph 95(2)(a)(v) applies only to income *from the disposition of property*, not to income *from* property, so it could never result in property becoming excluded property under (c).

VII. Pre-acquisition FAPI and Active Business Income

A. Pre-acquisition FAPI

The FAPI of a foreign affiliate is generally considered to be computed at the end of each of its taxation years, and to include all income and gains arising throughout each such year, even in reference to a taxpayer for whom the affiliate became a foreign affiliate in the course of the year. Thus, an affiliate's FAPI would include income realized or accrued during a taxation year in which, but before, it became a foreign affiliate of a particular taxpayer. Such a result is inappropriate, and is precluded in many circumstances with respect to capital gains and losses by the language in paragraph 95(2)(f). Accordingly, the principle reflected in paragraph 95(2)(f) is extended to income account items by new paragraph 95(2)(f.1). This provision excludes from the computation of an affiliate's income from property any income or loss that can reasonably be considered to have been realized or to have accrued during any period throughout which the affiliate was not a foreign affiliate of the taxpayer or of a person described in any of subparagraphs 95(2)(f)(iii) to (vii).

Certain additional changes have also been made in this context. First, there is a problem under the current language in paragraph 95(2)(f) which arises where a non-resident corporation disposes of property during its taxation year in which, but before, it becomes a foreign affiliate of a relevant taxpayer. Paragraph 95(2)(f) would not apply because this provision requires the property to be owned by the affiliate at the time it last became an affiliate, which would not be the case if the property was disposed of before the affiliate became an affiliate.[29] Accordingly, proposed subsection 95(2.22) provides that, in determining for the purpose of applying paragraph 95(2)(f) whether a particular property was owned by a non-resident corporation when it last became a foreign affiliate of a taxpayer, the corporation is deemed to have become a foreign affiliate of the taxpayer at the beginning of a taxation year of the corporation if the corporation was not a foreign affiliate of the taxpayer at the beginning of the year, the corporation was a foreign affiliate of the taxpayer at the end of the year, and a person has, in the year, acquired or disposed of shares of the corporation or of any other corporation and, because of that acquisition or disposition, the non-resident corporation became a foreign affiliate of the taxpayer.

[29] There is an argument that current paragraph 95(2.2) could have the effect of deeming an acquired affiliate to have become a foreign affiliate of the relevant taxpayer at the beginning of its taxation year which includes the acquisition, but the CCRA does not accept this interpretation and paragraph 95(2.2) is proposed to be amended to preclude this argument, by rendering it inapplicable for purposes of paragraph 95(2)(f). Arguably, paragraph 95(2.2) should also be rendered inapplicable for purposes of paragraph 95(2)(f.1).

However, in order to prevent proposed subsection 95(2.22) from causing the recognition of gains and losses which accrued between the beginning of the year and the actual time at which the affiliate became a foreign affiliate of the relevant taxpayer, proposed subsection 95(2.23) provides that subsection 95(2.22) does not apply in determining whether any taxable capital gain or allowable capital loss realized by a non-resident corporation can reasonably be considered to have accrued while the affiliate was not a foreign affiliate of any person specified in any of subparagraphs 95(2)(f)(iii) to (vii).

These measures are welcomed as a means of preventing the inappropriate recognition of "phantom FAPI". However, proposed subsection 95(2.22), as currently drafted, would not assist with respect to property acquired by an affiliate after the beginning of its taxation year in which it became an affiliate of the relevant taxpayer, but disposed of before the time it became such an affiliate. In that respect, it would be preferable if paragraph 95(2)(f) was amended to apply to property owned at the time of *or at any time after* an entity becomes a foreign affiliate.

In addition, as noted above, paragraph 95(2)(f) is amended to add a reference to property owned by a partnership. However, it appears that the reference to property owned by a partnership is somewhat incomplete. This is because the "midamble" excludes the portion of the gain or loss which accrued while the "affiliate" was not an affiliate of certain specified persons. Thus, if an existing affiliate acquires a partnership interest, and the partnership property has a latent gain, then paragraph 95(2)(f) would not apply to limit recognition of that gain to the extent that it accrued while the affiliate was an affiliate of specified persons, even if the partnership interest was not held by the affiliate (or any specified person) during that period. Arguably, this issue should be addressed, and corresponding changes should also be made to subsections 95(2.22) and (2.23). Similarly, references to "capital gains" and "capital losses" should also be added to proposed subsection 95(2.23), to render it more consistent with paragraph 95(2)(f).

Continuing concerns with paragraph 95(2)(f)

We also note that there are additional concerns that arise in this context. For example, there remain concerns in respect of transfers between both related and unrelated Canadian taxpayers.

In respect of transfers between related Canadian taxpayers, consider the following example: Canco 1 owns CFA, which holds appreciated investment property with an ACB of $100 and FMV of $1,000, so a latent FAPI gain of $900 exists. Canco 1 sells CFA to Canco 2, a related person resident in Canada, for $1,000 in cash, recognizing a capital gain of $900. Thus, the latent gain on the appreciated investment property has been realized. However, in applying paragraph 95(2)(f) in respect of Canco 2, the gain accrued during the period in which CFA was a foreign affiliate of Canco 1. Thus, if the

property were disposed of the very next day after Canco 2 acquired CFA, FAPI would be attributed to Canco 2, resulting in double taxation.[30]

Similarly, consider the following example for transfers between unrelated Canadian taxpayers: Canco 1 owns Canco 2, which owns CFA, which holds appreciated investment property with ACB of $100 and FMV of $1,000, so a latent FAPI gain of $900 exists. Canco 2 sells CFA to Canco 3, an unrelated person resident in Canada, for $1,000 in cash, recognizing a capital gain of $900. Thus, the latent gain on the appreciated investment property has been realized. Subsequently, Canco 1 sells Canco 2 to Canco 3.[31] In applying paragraph 95(2)(f) in respect of Canco 3, because Canco 3 becomes related to Canco 2, and because the gain accrued during the period in which CFA was a foreign affiliate of Canco 2, there is a possible reading of the relevant rules to the effect that paragraph 95(2)(f) does not apply. In other words, when subparagraph 95(2)(f)(iv) refers to "any person with whom the taxpayer was not dealing at arm's length", it is not clear that this language excludes the portion of the gain which accrued during the arm's length period.

While the first concern may be somewhat more complicated to address, we suggest that the second could be addressed quite simply by replacing the reference from subparagraph 95(2)(f)(iv) quoted above with the following reference: "any person with whom the taxpayer was not, *in that period*, dealing at arm's length".

B. Pre-acquisition active business income

Proposed subsection 95(2.21) is introduced to preclude income arising before a non-resident corporation becomes a foreign affiliate of a particular taxpayer from being included in computing the affiliate's income from an active business under paragraph 95(2)(a). This issue arises because of the deeming rules in subsection 95(2.2). Under paragraph 95(2.2)(a), a non-resident corporation which becomes a foreign affiliate of a particular taxpayer in respect of which the taxpayer has a qualifying interest during the course of a taxation year because of an acquisition or disposition of shares is deemed to have been such *throughout the year*. Similarly, under paragraph 95(2.2)(b), a non-resident corporation which becomes related to a particular taxpayer and to a foreign affiliate of the taxpayer during the course of a taxation year because of an acquisition or disposition of shares is deemed to have been such *throughout the year*.[32]

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[30] Actually, the double taxation would be temporary in a sense, in that Canco 2's ACB in the CFA shares would be increased beyond their FMV, so there would be a latent loss. This latent loss, however, would not fully compensate for the FAPI inclusion, because the loss would likely be on capital account, so could not be used to offset the FAPI.

[31] Assume that Canco 2 had previously paid out safe income dividends to Canco 1, bringing its FMV down to its ACB, so there is no gain to Canco 1 on this disposition.

[32] The FA Proposals amend paragraph 95(2.2)(b) to address a technical concern which arises where the non-resident becomes related to the taxpayer before the acquisition of shares because of a right to acquire shares to which paragraph 251(5)(b) applies. In these circumstances, it cannot be said that the non-resident

Accordingly, payments made by such a corporation to a foreign affiliate of the taxpayer in respect of which the taxpayer had (or was deemed to have) a qualifying interest throughout the year would seem to qualify for inclusion in the recipient affiliate's income from an active business under paragraph 95(2)(a). However, the price (and, therefore, the ACB) of the recipient affiliate shares which were acquired would presumably reflect the value of the accrued or realized income of the recipient affiliate, so it should not also be reflected in the recipient affiliate's surplus. Such surplus is sometimes referred to as "phantom surplus". The effect of this amendment, together with that of paragraph 95(2)(f.1), which precludes such income from resulting in FAPI, would be to cause such income to result in pre-acquisition surplus.

As currently drafted, it is not entirely clear that this provision would not extend to income earned after foreign affiliate status based on relationships established before. The current language (for example, in paragraph 95(2.21)(a)) provides that subsection 95(2.2) does not apply "to any income or loss … that relates to a transaction or event … that occurred before that particular affiliate became … a foreign affiliate". It is possible to interpret this language to describe income earned after foreign affiliate status. Where one entity makes a loan to another before foreign affiliate status, and interest is earned on that loan after foreign affiliate status, it could be said that the income earned after "relates" to the making of the loan, which is a "transaction" which occurred before foreign affiliate status. This no doubt is not the intention, so it would be preferable to change the language to clarify it in this respect.

Further, by virtue of proposed paragraph 95(2)(n), it appears that subsection 95(2.21) should not preclude deemed active business income from arising where a non-resident corporation that is a foreign affiliate of a taxpayer is transferred to another Canadian taxpayer that is related to the taxpayer. Thus, it is submitted that, if paragraph 95(2)(n) is narrowed so that it only applies for purposes of paragraph 95(2)(a), it should also apply for purposes of subsection 95(2.21).

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corporation becomes related because of the share acquisition or disposition, since it was related before that event.

VIII. Investment Business

A. Equivalent services

Under the current rule, the "equivalent to more than five" full-time employee test can be met with services provided by employees of a corporation related to the relevant affiliate (other than because of paragraph 251(5)(b)) or non-specified members of the partnership. In addition, based on the current language, it appears that services procured by a partnership can be provided by either employees of its members or employees of any corporation related to an affiliate that is a member.

Under the proposed amendment, this test could be met with services provided by employees of a corporation related to the relevant affiliate (other than because of paragraph 251(5)(b)) or, if the business is carried on in a partnership, by employees of a qualifying member of the partnership, and if the business is not carried on in a partnership, by employees of a "qualifying shareholder" of the affiliate. Thus, if the services are provided by employees of an unrelated person, that person must be a qualifying member of the partnership or, if there is no partnership, a "qualifying shareholder" of the affiliate.

Recommendations for amendments to equivalent services rule

There is no provision explicitly contemplating services provided to a partnership by another partnership, unless the latter is a qualifying member of the former, and the rule should probably be clarified in this respect.[33] In addition, this provision could also reasonably be expanded to permit services to be provided to a partnership by another partnership if both partnerships have a common qualifying member, and in certain other circumstances. Similarly, the provision applicable to services provided by employees of a qualifying shareholder could also reasonably be expanded in certain respects. For example, this definition, as currently drafted, lacks a look-through rule for corporations like that applicable under the definition of "qualifying interest", and those applicable to the definition of "qualifying member" and "qualifying shareholder" for partnerships and trusts.

Another reasonable expansion of this rule would be to permit the employees of related foreign affiliates (and partnerships of which such affiliates are qualifying members) who are actively engaged in the conduct of similar and related businesses (defined appropriately) to be aggregated for the purposes of relevant affiliates (or partnerships) satisfying the "more than five" full-time employee test.

[33] Under proposed paragraph 95(2)(o), which refers to a "person", it is not clear that a partnership could ever be a qualifying member of another partnership.

Under current rules, at least one of the related affiliates must alone satisfy the "more than five" full-time employee test (i.e., the "mother ship"), and then the income of other related affiliates (which do not satisfy the "more than five" full-time employee test) can be recharacterized as active business income to the extent that paragraph 95(2)(a) applies.

However, given that the purpose of this test is to distinguish business activities which require substantial foreign manpower from those which do not, it seems to be difficult to understand why those business activities should not qualify where the required level of employee involvement is present within a related group overall, but distributed in such a way that no single member alone has more than five full-time employees, for business reasons.

Many foreign real estate operations, for example in the U.S., typically involve multi-tier corporate structures to accommodate business requirements that are unrelated to income tax considerations, either under the Canadian foreign affiliate rules or under the domestic tax rules of the host country. In order for foreign subsidiaries of Canadian corporations to compete effectively in these markets, it is imperative that the same structures and protections from liability and the same opportunities for involving third party mezzanine financing or equity participations be available to them. If the Canadian parent corporations face adverse Canadian income tax issues under the foreign affiliate rules if they operate in the same manner as their foreign-based competitors, it will unduly restrict Canadian companies from operating globally in the real estate sector.

The experience in the U.S. real estate market, where Canadian developers have the greatest opportunity to operate, is a good example. American real estate developers typically develop each real estate project in a separate entity, such as a limited liability company. The reason for this is to enhance the opportunity for obtaining stand-alone project financing and thereby reduce cross-covenants and cross-collateralization between projects. It is much simpler to achieve this from a legal perspective through the use of separate entities than through interweaving numerous financial agreements between a single entity and numerous lenders. In addition, in recent years, the number of law suits commenced against real estate developers in the highly litigious environment and class action suits in the U.S. has required developers to develop each project in a separate entity as means of limiting risk for the corporate group. Insurance for construction liabilities is becoming increasingly difficult to obtain and is highly expensive, and in many cases it has required the developer to become a self-insurer. These insurance considerations also require separate entities. A further commercial element for the stand-alone project entity is to permit the developer to bring equity participants and mezzanine participating lenders into a project. Typically these capital sources wish to make investments in single projects rather than in a whole portfolio of development projects. These participations usually require multi-tier structures in order to bring in each layer of capital at the right level of priority and participation in profits. It is not unusual for the chain to involve three to four layers for each project, with different third parties having a stake at each level.

Because each project is in a separate entity and goes through various phases in the development process, from obtaining approvals, to construction and sales, it is not always the case that six full time employees or their equivalents are required to be employed by the project entity throughout the entire development phase. Furthermore, the sales process may well involve third party brokers who are expert in a particular market place or third party marketing consultants. Many real estate developers in the U.S. may employ 20 to over 100 full-time employees in the corporate group but do not assign specific employees to specific project entities. The group as a whole is engaged in a large and active real estate development operation, but as each project is in a subsidiary entity for the business reasons described above, a Canadian company that sought to duplicate the optimum structure used by its U.S. competitor could find itself with foreign accrual property income under the Canadian tax rules, as they are currently drafted and interpreted by the CCRA.

The commercial reasons for maintaining all the employees in a separate entity in the corporate group is for continuity of employment relationships, protection of the employee, administration and continuity of benefit plans, pension entitlements and seniority for salary and vacation entitlement. The employees can be deployed as needed and when needed to work on the various projects held by the project entities. The concentration of employees in one entity also results in administrative efficiencies for the employer. In order for Canadian businesses to be able to participate and compete in the U.S. real estate development industry sector, they must be able to operate under the same business structures as their U.S. competitors.

The fact that each member of the related group may be carrying on a separate business in and of itself should not be a material consideration in this regard. Indeed, the business of a related affiliate that, for example, satisfies the current rules in subparagraph 95(2)(a)(i) would be a separate business from that carried on by the "mother ship" affiliate. Moreover, as noted above, the proposed definition of "qualifying member" of a partnership would include a member that is either actively engaged in the principal business of the partnership, <u>or in a "similar" business of its own</u>. Thus, in that context, a partner being actively engaged in a business that is similar to the principal business of the partnership constitutes a <u>sufficient connection</u> so as to permit an association of the two businesses for Canadian tax purposes, even if the activities of one business are not directly related to the activities of the other business.

In our view, given that the context of determining whether or not a particular affiliate is a qualifying member of a partnership is not at all unrelated to the context of determining whether or not a business is an investment business – indeed, the qualifying member concept applies in the context of determining whether or not a business is an investment business – such a connection should also be sufficient for the purposes of determining whether or not the "more than five" employee test has been satisfied.

Moreover, the absence of such an aggregation rule, coupled with a rule which would appropriately define what a similar business is, often can give rise to very anomalous consequences.

For example, in a Technical Interpretation dated October 26, 2000 (2000-0044387), the CCRA expressed the view that subparagraph 95(2)(a)(i) would not apply to the income of a number of U.S. real estate holding companies, even though their U.S. parent's employees provided managerial, administrative, financial, maintenance, and other services to each of the real estate holding companies. The services enabled the real estate holding companies to acquire raw, undeveloped land, make rezoning applications for development, subdivide the property, fully service the property by putting in place utility connections such as water, sewage, hydro, gas, telephone and build roads so as to provide fully serviced lots available for sale individually or en bloc to building contractors. Management fees were charged by the parent to recoup its cost of providing these services to the real estate holding companies. Because no land was held by the parent for development on its own behalf, the CCRA concluded that the parent was engaged in a management services business, which they regarded as a separate business from the real estate development business of each of the real estate holding companies. On that basis, they determined that, if the income of each of the real estate holding companies (considered individually) were earned by the parent, the parent would be earning income from an investment business, so the second condition in that subparagraph could not be met. The CCRA did not reach the conclusion that the relevant analysis could be carried out on the assumption that the parent hypothetically held all the land owned by all of the real estate holding companies. Had it done so, it might have concluded that the second condition would have been satisfied.

In a Technical Interpretation dated September 2, 1999 (9622545), the CCRA took the position that the business of providing geological and administrative services was different from the resource exploration and exploitation business. In this interpretation, a particular foreign affiliate (FA3) employed 6 full time employees who provided exploration, geological and administrative services outside Canada solely to related foreign affiliates (FAl and FA2) on a cost recovery basis (i.e. for compensation the value of which was not less than the cost to FA3 of those services), and concluded that subparagraph 95(2)(a)(i) would not apply.

In a Technical Interpretation dated August 24, 1999 (9701345), the CCRA not only took the position that the activities of the "mother ship" and of the "satellite" affiliates must constitute a "single business" in order for subparagraph 95(2)(a)(i) to apply, they also expressed the view that the mother ship's business would not be an active business if it had only 6 employees, to the extent that any of the time of such employees were spent on activities of a satellite affiliate.

These interpretations clearly give rise to anomalous consequences. They deal with factual situations in which there is clearly sufficient foreign manpower required and provided through group employee involvement, yet the income (other than the services income of the parent) remains passive.

To make matters worse, the proposed amendment to paragraph 95(2)(b) would also recharacterize the parent's services income as passive income.

In a somewhat related context – namely, where a regulated foreign bank would acquire interests in a limited partnership holding securities with reference to which the bank would issue derivative instruments like total return swaps, as a means of covering its position, the CCRA took the position that the bank's share of the income of such partnerships would not be regarded as being part of its active business income but rather to be income from a separate business which had to be characterized on its own, on the basis of their view that a business carried on by a partner through a partnership is "always" separate and distinct from any business that the partner may carry on directly. [See the Technical Interpretation dated December 1, 1997 (8M17870F).] If the business of a partnership is "always" separate from that of its partners, it seems difficult to see how the standard used by the CCRA in the context of subparagraph 95(2)(a)(i) – i.e., two affiliates carrying on a "single business" – could ever be met, unless the affiliates are in partnership.

Finally, we remain unclear as to why the status of the employer is even relevant at all. That is, if as noted above the purpose of the more than five employee test is to distinguish business activities that require substantial foreign manpower from those which do not, why should it matter that the manpower is procured under a contract of employment *versus* independent contractorship? This may be particularly inappropriate in certain industries, like the real estate industry, where the use of contractors (i.e., management and service companies) is industry practice. In addition, in some cases practical efficiencies can be achieved by "outsourcing" employees.

Therefore, we submit that the definition of investment business should be revised so as to address the concerns articulated above, as follows:

(i) A new paragraph (c) should be introduced, which would permit the aggregation of employees of related affiliates (or partnerships of which related affiliates are qualifying members) who are actively engaged in the conduct of a similar businesses.[34]

(ii) Either there should be no restriction on the identity of the employer for the purposes of the "equivalent to more than five" full-time employee test; or, the reference to "a person who was a qualifying member of the partnership" should be replaced with a broader reference, perhaps to:

- a person or partnership who was a qualifying member of the particular partnership;

[34] While it would be our view that an overall employee aggregation rule would be the most appropriate, it would most likely be an acceptable compromise for most taxpayers if a geographically-limited aggregation rule were adopted – for example, on a country-by-country basis or, in certain circumstances (e.g., for European groups), on a continental basis.

- a partnership of which the qualifying members includ: a person or partnership that was a qualifying member of the particular partnership; another foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest throughout the year, or a qualifying shareholder of such an other affiliate; a qualifying shareholder of the affiliate; or a person related to the affiliate (otherwise than because of a right referred to in paragraph 251(5)(b)).

(iii) Similar changes to accommodate services provided by partnerships should also be considered with respect to the scope of clause (b)(ii)(A) of the definition.

(iv) The definition of "qualifying shareholder" should be revised to make the following additional provision:

"and for the purposes of this paragraph

(v) where, at any time, shares of a corporation are owned or are deemed for the purposes of this paragraph to be owned by another corporation (in this paragraph referred to as the "holding corporation"), those shares shall be deemed to be owned at that time by each shareholder of the holding corporation in a proportion equal to the proportion of all such shares that

(A) the fair market value of the shares of the holding corporation owned at that time by the shareholder

is of

(B) the fair market value of all the issued shares of the holding corporation outstanding at that time; and"

(v) In addition, given the uncertainty resulting from the various CCRA Technical Interpretations referred to above, we recommend that subparagraph 95(2)(a)(i) be clarified such that it would be applicable without any doubt in circumstances in which a foreign affiliate group is divided into, for example, one affiliate which has all the employees and other affiliates which have no employees and instead are used to hold distinct properties or otherwise to carry out distinct functions, provided that such properties and functions are managed or coordinated by the employees of the employee affiliate. We note that in a Technical Interpretation dated February 24, 1992 (9118915), the CCRA took the view that former subparagraph 95(2)(a)(i) would be applicable in this very situation, and it is our understanding that the 1994 amendments to this provision were not intended to narrow its scope in this respect.

B. Regulated businesses

The FA Proposals relax the regulation requirements for certain types of business to some extent. That is, under current subparagraph (b)(i) of the definition of "investment business", the business carried on by an affiliate as a listed financial institution only qualifies if it is regulated "in the country in which the business is principally carried on". A proposal to relax this requirement was introduced with the draft legislation dated August 2, 2001, and this proposal has essentially been carried forward in the FA Proposals, with certain modifications. Under the current proposals, the regulation requirement will be met if the activities of the business are regulated under the laws:

(A) of each country in which the business is carried on and of the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued,

(B) of the country in which the business is principally carried on, or

(C) if the affiliate is related to a non-resident corporation, of the country under whose laws that non-resident corporation is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued, if those regulating laws are recognized under the laws of the country in which the business is principally carried on and all[35] of those countries are members of the European Union.

Concerns with clauses (A),(B) and (C)

Clause (A) remains somewhat stringent, in that non-regulation in any one country in which the business is carried on results in non-qualification. Clause (B) sets a lower standard, but requires that it be possible to establish that the business is principally carried on in a particular country. Clause (C) is intended to deal with circumstances involving mutual regulatory recognition among members of the European Union, and also requires that it be possible to establish that the business is principally carried on in a particular country.

One question which arises is why all this is necessary. First, why is regulation in the country of governing law necessary? Arguably, if regulation in the country of governing law is necessary under clause (B), why is it not also necessary under clause (A)? If regulation in the country of governing law is not necessary under clause (A), why is it also not necessary under clause (B)?

Second, if the long formulation (i.e., the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued) is intended to cover cases where there has

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[35] The reference to "all" should probably be replaced with a reference to "both" if satisfying the conditions with respect to any one related non-resident is sufficient.

been continuance without discontinuance, then the reference to "exists" is inappropriate, since in those cases the affiliate would likely exist under laws of two countries.

Finally, some *de minimis* standard should be incorporated into clause (A). For example, a rule like that in Regulation 5906 could be introduced to deem a business to be carried on in a country only to extent that it is carried on in that country through a permanent establishment. This would prevent regulation being required in countries where there is an insubstantial presence only.

It is submitted therefore that this proposal should be modified such that clauses (A) and (B) are essentially combined, and that regulation is required under the laws of the country or combination of countries in which activities of the business are principally carried on, excluding activities carried on in a country other than through a permanent establishment in such country.

There is also an ambiguity in clause (C). If a particular affiliate is related to two other non-resident corporations, and one is governed by the laws of a country which has regulations which are recognized in the country where the business is principally carried on, and the other is governed by the laws of a country which does not have regulations which are recognized in the country where the business is principally carried on, it is not clear whether the activities of the particular affiliate would qualify.

Arguably, it ought to be possible to meet the test in clause (C) if its conditions are satisfied in respect of *any one* other non-resident corporation to which the particular affiliate is related, and this provision should perhaps be clarified in this respect.[36]

C. Arm's length business requirement

The FA Proposals expand the scope of paragraph 95(2)(b) so that it also applies where the consideration for the services is deductible (or could reasonably be considered to relate to an amount that is deductible) in computing the FAPI of a controlled foreign affiliate of any person in relation to whom the particular affiliate is a controlled foreign affiliate, or of any person related to such a person. The introduction of such an extension to paragraph 95(2)(b) would have implications with respect to the definition of "investment business".

[36] Corresponding changes would also be made to subparagraph 95(2)(l)(iii), which applies in certain circumstances to include income from an affiliate's lending activities in computing its income from property.

Currently, a business cannot be excluded from being an investment business, even if it employs more than five full-time employees, if it is conducted principally with non-arm's length persons. This provision prevents taxpayers from arranging their affairs in such a way as to "shift" income from a passive source into an active source, and would not be questionable in the absence of a rule like the one proposed to be added to paragraph 95(2)(b) to more directly prevent such a shifting.

However, in the presence of such an anti-passive-income-shifting rule, it becomes much more difficult to justify any distinction between a business which is conducted principally with non-arm's length persons and a business which is conducted principally with arm's length persons. Because of the extension to paragraph 95(2)(b), it would be impossible for a taxpayer to arrange its affairs in such a way as to obtain any material Canadian tax benefit by shifting passive income into a related affiliate which employs more than five full-time employees (the "active affiliate"). Such income will remain passive in the hands of the active affiliate. Therefore, there is no need for any restriction against an active affiliate conducting its business principally with non-arm's length persons.

Accordingly, we submit that, if paragraph 95(2)(b) is extended as described above, the restriction in the definition of "investment business" against an affiliate conducting its business principally with non-arm's length persons should be deleted.

D. Specified business requirement and paragraph 95(2)(l)

We are concerned about the existence of the specified business requirement, which limits the types of business which are permitted to satisfy the "more than 5 employee" test to those specified in paragraph (a) of the definition of "investment business". If a particular entity employs more than five full-time employees (or the equivalent thereof) in the active conduct of a particular business, and therefore meets the prescribed threshold of employee activity, then why is the precise nature of that business relevant? We have difficulty seeing any persuasive reason for distinguishing between types of business in this context. Accordingly, we recommend that this requirement be repealed.

In addition, it is not clear that an affiliate can satisfy the specified business requirement if the affiliate's business constitutes a combination of the specified types. Thus, we recommend that, at a minimum, the specified business requirement include a category which covers any combination of the specified types.

Along similar lines, it seems difficult to understand why certain types of business – in particular, those described in paragraph 95(2)(l) – should be altogether disqualified from active business status simply because of the nature of their activities. It is our view that the Canadian tax base is adequately protected from erosion resulting from business operations involving earnings from indebtedness without paragraph 95(2)(l). The definition of "investment business" addresses the concern arising in connection with businesses that do not require material employee activity. Moreover, paragraph 95(2)(a.3) protects the Canadian tax base from businesses involving indebtedness of persons resident in Canada or in respect of businesses carried on in Canada. If the business has material employee activity, and is not eroding the Canadian tax base in the sense that it does not involve indebtedness that gives rise to deductions in computing income that is taxable under the Act, then why should it be deemed to be passive? In the absence of any persuasive justification of this discriminatory treatment, we recommend that paragraph 95(2)(l) be repealed.

IX. Non-active Business Income

The FA Proposals introduce a number of amendments to the various rules that deem certain income to be income from a business other than an active business (i.e., paragraphs 95(2)(a.1) to (a.4), paragraph 95(2)(b), and various supporting rules).

A. Paragraph 95(2)(a.1) and the definition of "designated property"

Paragraph 95(2)(a.1) sets out the rule which deems certain income of an affiliate from the sale of property to be from a business other than an active business. The current rule provides for a technical exception in respect of property that was manufactured, produced, grown, extracted or processed in Canada by the taxpayer or a non-arm's length person in the course of carrying on a business in Canada (and that was sold to non-resident persons other than the affiliate or sold to the affiliate for resale to other non-resident persons).

The FA Proposals replace the reference to "property that was manufactured, produced, grown, extracted or processed in Canada by the taxpayer or a non-arm's length person in the course of carrying on a business in Canada" with a reference to "designated property", which is defined to describe a broader universe of property. This definition, contained in new subsection 95(3.1), describes property the income from the sale of which is included in computing the income of a foreign affiliate of a taxpayer resident in Canada if that property also meets one of three alternative[37] additional descriptions – namely, that:

(a) the property was manufactured, produced, grown, extracted or processed in Canada by the taxpayer, or by a person with whom the taxpayer does not deal at arm's length, in the course of carrying on a business in Canada (along the lines of the current exception);

(b) the property was acquired by the taxpayer or a non-arm's length person resident in Canada, in the course of carrying on a business in Canada, from an arm's length person other than a foreign affiliate of the taxpayer (or of a non-arm's length person); or,

[37] These descriptions are set out in proposed paragraphs 95(3.1)(a), (b) and (c). Paragraphs (b) and (c) are separated by an "and", which seems to be inappropriate in the context. Arguably, this reference should be replaced with a reference to "or".

(c) the property was acquired by the taxpayer or a non-arm's length person resident in Canada from a foreign affiliate of the taxpayer (or of a non-arm's length person resident in Canada) and was manufactured, produced, grown, extracted or processed in the country under whose laws the vendor is governed and any of exists, was (unless the vendor[38] was continued in any jurisdiction) formed or organized, or was last continued and in which the vendor's business is principally carried on.

Thus, the property need not be manufactured, etc., by the taxpayer (or a non-arm's length person). It can be acquired by the taxpayer (or a non-arm's length person) from an arm's length person, other than a foreign affiliate of the taxpayer (or of a non-arm's length person), unless the property was manufactured, etc., by the affiliate in the country under the laws of which the affiliate is governed.

The definition of "designated property" refers to "property the income from the sale of which is included in computing the income of a foreign affiliate". This language does not appear to be technically appropriate in this context. Paragraph 95(2)(a.1) applies both to income from the sale of property <u>and</u> to income from services in connection with the sale of property. Thus, if the reference to "designated property" is intended to exclude both sales to non-residents made indirectly through the affiliate (in which case the affiliate has income from sale of property) <u>and</u> sales made directly by the taxpayer (in which case the affiliate has income from services, but not from the sale of property), then defining "designated property" by reference to whether its sale results in income from the sale of property in the affiliate's hands will preclude property sold directly by the taxpayer to a non-resident other than the affiliate from being designated property.

We therefore recommend that the opening language of this provision after the word "means" should be deleted, such that this provision would simply read as follows:

> "For the purpose of subparagraph (2)(a.1)(i) [and paragraph (e) of the definition of "investment property" in subsection (1)],[39] "designated property" means … (a) …".

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[38] It should be noted that subparagraph 95(3.1)(c)(iii) actually (although arguably inaccurately) refers to the "affiliate" rather than to the "vendor" in its parenthesized language.

[39] See the discussion that follows immediately below.

Further, the definition of designated property should be expanded to include situations in which goods owned by a taxpayer resident in Canada are manufactured by a foreign affiliate under a contract manufacturing arrangement.[40] Our suggested wording for revised proposed paragraph (a) would be as follows:

> "(a) property that was, in the course of carrying on a business in Canada,
>
> (i) manufactured, produced, grown, extracted or processed in Canada by the taxpayer, or by a person with whom the taxpayer does not deal at arm's length or
>
> (ii) *manufactured or processed outside Canada, in accordance with the taxpayer's specifications and under a contract with the affiliate, from tangible property that is owned by the taxpayer*"

A similar concern also arises in the context of the definitions of "investment business" and "investment property", in that the latter may in certain circumstances include commodities,[41] except to the extent they are manufactured, etc., by the affiliate or a related person.

We submit that the language between the parentheses in paragraph (e) of the definition of "investment property" referring to "except commodities … or commodities futures in respect of such commodities" be replaced with language along the following lines:

> *"except commodities which are designated property or commodities futures in respect of such commodities".*

As well, we feel that the scope of paragraph 95(2)(a.1), as currently drafted, is far too broad. In particular, we recommend that the scope of this paragraph be restricted to "tangible property". Income from intangible property is already covered by paragraph 95(2)(a.3).

Alternatively, if the scope of paragraph 95(2)(a.1) is not restricted to tangible property, then the scope of the exception for "designated property" should be expanded to clearly cover certain intangibles that could reasonably regarded as having been created in the relevant foreign jurisdiction. For example, where a foreign affiliate of a financial institution puts together a composite or other financial product, and then transfers its position under that product to the financial institution, it would be reasonable to consider that the affiliate created the relevant "property" arising under or as a result of that product in the relevant foreign jurisdiction. Accordingly, the transfer of such "property" should be regarded as a transfer of "designated property".

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[40] Such a change would be consistent with new paragraph 95(3)(d).

[41] See paragraph (e) of that definition.

B. Paragraph 95(2)(a.3)

Subsection 95(2.4) sets out an exception to paragraph 95(2)(a.3) in respect of certain activities of certain regulated foreign financial institutions. The FA Proposals amend paragraph (a) of this rule, which sets out a regulation requirement similar to the one applicable in the context of the "investment business" definition. The proposed amendment adjusts the language of this regulation requirement along the lines of the language described above in the context of the "investment business" definition.[42]

In addition, proposed subsection 95(2.41) sets out an exception to paragraph 95(2)(a.3) in respect of Canadian indebtedness used or held by an affiliate carrying on a foreign life insurance business, provided that certain conditions are met.[43] These include the condition that the relevant Canadian taxpayer be (or be a subsidiary controlled corporation of) a life insurance corporation regulated by OSFI (or a similar provincial authority). The affiliate's foreign life insurance business will also be required to meet certain foreign regulation requirements. Interestingly, this enumeration of foreign regulation requirements does not include a category intended to deal with circumstances involving mutual regulatory recognition among members of the European Union. Certain additional conditions would also have to be met in relation to the source of the affiliate's gross premium revenues, and it would have to be reasonable to conclude that the affiliate used or held the Canadian indebtedness to fund a liability or reserve of the foreign life insurance business or as capital reasonably required for the foreign life insurance business.

C. Paragraph 95(2)(b)

Currently, paragraph 95(2)(b) applies only in respect of services (or an undertaking) provided by a controlled foreign affiliate. The FA Proposals expand it to apply in respect of services (or an undertaking) provided by any foreign affiliate.

Furthermore, the current provision applies only if the consideration for those services is deductible (or could reasonably be considered to relate to an amount that is deductible) in computing the income from a business carried on in Canada of certain specified persons in relation to the particular affiliate. The FA Proposals expand it to also apply where the consideration for the services is deductible (or could reasonably be considered to relate to an amount that is deductible) in computing the FAPI of a controlled foreign affiliate of any person in relation to whom the particular affiliate is a controlled foreign affiliate, or of any person related to such a person.

[42] A similar proposal was introduced by the Technical Bill dated August 2, 2001.

[43] A similar proposal was introduced by the Technical Bill dated October 12, 2000.

Finally, the FA Proposals amend the supporting rule in subsection 95(3) to restrict the scope of paragraph 95(2)(b) by excluding from the meaning of the word "services" the transmission of electronic signals or electricity along a transmission system located outside Canada, as well as certain contract manufacturing services carried out for the taxpayer (specifically, the manufacturing or processing outside Canada, in accordance with the taxpayer's specifications and under a contract between the taxpayer and the affiliate, of tangible property that is owned by the taxpayer if the property resulting from the manufacturing or processing is used or held by the taxpayer in the ordinary course of the taxpayer's business carried on in Canada).

Unlike paragraphs 95(2)(a.1) to (a.3), paragraph 95(2)(b) does not provide for any *de minimis* exception. Given the overlapping scope of paragraph 95(2)(b) and paragraph 95(2)(a.2), the lack of a *de minimis* exception in paragraph 95(2)(b) in some cases results in a frustration of the legislative purpose of the *de minimis* exception in paragraph 95(2)(a.2). In addition, from a more general perspective, it seems difficult to understand why paragraphs 95(2)(a.1) to (a.3), but not paragraph 95(2)(b), should have a *de minimis* exception. We therefore recommend that a *de minimis* exception should be incorporated into paragraph 95(2)(b).

X. Life Insurance Corporations

Each of subparagraph 95(2)(a)(i) and clause 95(2)(a)(ii)(E) provides for inclusions in computing the income or loss from an active business of an affiliate in respect of activities which relate to the non-Canadian life insurance operations of the relevant taxpayer. It is appropriate that such activities, and the income or loss therefrom, be treated as being active because the taxpayer would be exempt from tax under Part I of the Act in respect of such income pursuant to subsection 138(2).

The FA Proposals expand these provisions to cover circumstances in which the Canadian insurance company is either a person who controls the relevant taxpayer or is controlled by the relevant taxpayer, in addition to circumstances in which the Canadian insurance company is the taxpayer. What seems to be an oversight is that this extension would not cover circumstances in which the Canadian insurance company is under common control with the taxpayer (i.e., a sister).

Another oversight appears to have occurred in the context of certain of the corresponding Regulations, being proposed clause (d)(ii)(B) of the definition of "exempt earnings" and proposed clause (c)(ii)(B) of the definition of "exempt loss". These proposed provisions, as currently drafted, do not refer to circumstances in which the Canadian insurance company is either a person who controls the relevant taxpayer or is controlled by the relevant taxpayer. Interestingly, the Regulations corresponding to clause 95(2)(a)(ii)(E), being proposed clause (d)(ii)(I) of the definition of "exempt earnings" and proposed clause (c)(ii)(I) of the definition of "exempt loss", do refer to such circumstances.

A number of these provisions in the Act provide relief only to the extent that the related activities of the relevant Canadian insurance company is of such a nature as would allow them to be treated as active business activities if that company were a foreign affiliate of the taxpayer. Moreover, some of the ones in the Regulations provide exempt earnings treatment only to the extent that the related activities of the relevant Canadian insurance company would give rise to exempt earnings or loss if it were a foreign affiliate of the taxpayer. Why this standard is appropriate is not at all clear. This is, after all, income from activities that would be exempt in the hands of the relevant Canadian insurance company, regardless of whether such income would constitute "income from an active business" as defined in subsection 95(1), and regardless of whether it is earned in a designated treaty country. Arguably, the income of the affiliate should be active, and should be included in its exempt earnings, as long as it would be exempt in the hands of the relevant Canadian insurance company, and no other conditions should be imposed.[44] It should be noted that this is exactly the standard applicable under proposed clause 95(2)(a)(ii)(E), and the same standard should also be applicable under the other relevant provisions.

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[44] Indeed, the affiliate should not even be required to be resident in a designated treaty country, so these provisions should be moved out of paragraph (d) of the definition of "exempt earnings" and paragraph (c) of the definition of "exempt loss".

In addition, proposed clause 95(2)(a)(i)(A)(II) refers to “a life insurance corporation that is resident in Canada throughout the year”. Arguably, a supporting rule such as the one in subsection 95(2.2) should be added to address circumstances in which a life insurance corporation is formed part way through a particular taxation year, and similar circumstances.

Moreover, proposed clause 95(2)(a)(i)(A)(II) refers to a life insurance corporation “that is the taxpayer, a person who controls the taxpayer or a person controlled by the taxpayer”. Arguably, this reference should be expended to include a corporation that is under common control with the taxpayer (i.e., a sister corporation). A similar extension should be made to corresponding references that appear in proposed clause 95(2)(a)(i)(B)(II), and in corresponding Regulations.

XI. Miscellaneous Technical Issues and Drafting Points

A. Relevant tax factor (RTF)

The FA Proposals amend the definition of "relevant tax factor" in subsection 95(1), to account for the corporate tax rate reductions currently being implemented. The coming into force of this provision is set as 2002 and subsequent years, rather than 2001 and subsequent years. Arguably, the latter is the more appropriate.

Moreover, it is difficult to understand why the rule for partnerships should be so onerous. That is, where a partnership includes a single individual as a member, the partnership's RTF becomes 2.2. This of course adversely affects every corporate taxpayer that is in a partnership that includes an individual, where the partnership holds a CFA. Arguably, a more appropriate approach in this context would be to have a rule which determines a partnership's RTF on the basis of a formula which operates as a function of the relative fair market values of interests therein held by its various members, coupled with an interpretive rule which would make it clear that, notwithstanding section 103, partners may agree to allocate income resulting from FAPI attribution with reference to whether a particular member is or is not a corporation, in order to take into account the effect of that member's status on the partnership's RTF.

B. Drafting Points

We would also like to point out the following drafting points:

(i) Proposed clauses 95(2)(k.5)(ii)(A) and (B) appear to refer to the same thing – being activities deemed by any of paragraphs (a.1) to (b) to be a separate business. Thus, the purpose or effect of having these two separate clauses is not clear.

(ii) The reference to the plural "includes" in the opening language of proposed subparagraph 95(2)(k.5)(ii) should be replaced with the singular "include".

(iii) The reference, in proposed clause 95(2)(o)(ii)(A) dealing with "qualifying member" of a partnership, to "all partnership interests in the partnership owned by the particular person" is inconsistent with the CCRA's stated policy to the effect that each partner can only have one interest in a partnership. While it is not at all clear that the CCRA's position in this regard is correct, particularly where a partner holds interests with different characteristics (such as limited partner and general partner interests), we thought we should point out the inconsistency in the hope that the resulting uncertainty could be resolved.

(iv) As noted above, the FA Proposals amend paragraph 95(2.1)(c). Proposed subparagraph 95(2.1)(c)(i) refers to agreements entered into by an affiliate in the course of carrying on a business "principally with persons with whom the affiliate deals at arm's length". This reference is inappropriate or at least circular in a provision that is intended to deem the affiliate to be dealing at arm's length with non-arm's length persons.

One way to resolve the circularity would be to delete this reference and to add the following words at the end of this subparagraph:

> *"where the business would be carried on principally with persons with whom the affiliate deals at arm's length if those agreements were entered into with persons with whom the affiliate deals at arm's length".*

Corresponding changes should also be made to proposed subparagraph 95(2.1)(c)(ii). A similar circularity concern arises, for which we recommend a similar remedy, with respect to subsections 95(2.3) and (2.4) and the definitions of "indebtedness" and "specified deposit" in subsection 95(2.5).

XII. Other Miscellaneous Matters

The Committee would also like to raise the following comments and concerns:

(i) The FA Proposals substitute paragraphs 95(2)(d.1) and (e.1). In this context, we recommend replacing the reference to "surplus entitlement percentage" with a reference to "equity percentage". This change would determine a taxpayer's entitlement to rollover treatment as a function a more readily ascertainable and more stable criterion, and thereby would facilitate foreign affiliate reorganizations. The "equity percentage" concept is more stable because it does not vary annually in accordance with the earnings of the relevant affiliate, and is not distorted by deficits at different levels within a corporate group.

In addition, we understand there is a concern which arises under Regulations 5905(10) to (13), in calculating a taxpayer's surplus entitlement percentage in the context of a multi-tiered structure where there is a deficit at a higher tier which offsets surplus at a lower tier. This concern would not arise in the context of paragraphs 95(2)(d.1) and (e.1) if they were amended to use equity percentage rather than surplus entitlement percentage. We therefore recommend such an approach.

(ii) In the context of proposed paragraph 95(2)(e.1), we recommend adding a proviso to the effect that "this paragraph does not apply in respect of any property distributed to a person other than another foreign affiliate of the taxpayer". This would preclude the argument that proposed paragraph 95(2)(e.1) could apply in respect of property distributed to a shareholder resident in Canada.

(iii) The FA Proposals amend the language between subparagraphs 95(2)(f)(ii) and (iii). In this context, we recommend that the reference to "at the time the affiliate last became a foreign affiliate of the taxpayer" be replaced with a reference to "at or after the time the affiliate last became a foreign affiliate of the taxpayer". This language would address circumstances in which property was acquired by a non-resident corporation after the beginning of its taxation year in which it became a foreign affiliate and was then disposed of during that year but before the non-resident corporation became a foreign affiliate.

(iv) Proposed paragraph 95(2)(i) provides a rule that would deem to be from excluded property a gain or loss in respect of certain indebtedness, provided a specified "use test" is satisfied. We recommend that subsection 20(3) be expanded such that it would apply for the purposes of proposed paragraph 95(2)(i).

(v) Paragraph 95(2)(j) and Regulation 5907(12) apply in determining the ACB of a partnership interest to a foreign affiliate. We recommend that these provisions be revised to also extend to determining the ACB of a partnership interest to a partnership of which a foreign affiliate is a direct or indirect member.

(vi) The rules applicable under Regulation 5903 to the continuity of “deductible loss” in the context of mergers and liquidations are somewhat unclear and difficult to apply. We recommend that these rules be redrafted in certain respects.

(vii) Finally, we note that there remain outstanding a number of other items which the Committee has brought to the Department’s attention in earlier submissions. One example is the uncertainty surrounding the application of subparagraph 95(2)(a)(ii) in respect of interest paid by an affiliate on money borrowed to acquire an interest in a partnership that carries on an active business. We would be pleased to review these matters with you further at your convenience.

XIII. Coming Into Force of the FA Proposals

Most of the FA Proposals are set to come into force with effect after announcement date, or with effect for taxation years that begin after announcement date, which is December 20, 2002. Some, however, are set to take effect after 1999 or 2001, or for taxation years that begin or end after 1999 or 2001.

In addition, the FA Proposals provide for two elective effective date rules. The first, referred to as the “Global Section 95 Election” permits a taxpayer to elect that a number of the proposed amendments (listed in subsection 39(39)) will take effect for all taxation years of all foreign affiliates of the taxpayer that begin after 1994. A separate election is also provided for in respect of the proposed new fresh start rules, referred to as the “Fresh Start Section 95 Election”, in accordance with subsection 39(40).

A. Global Section 95 Election

Included in the FA Proposals are a number of amendments to section 95 and to Regulation 5907 that apply to taxation years, of a foreign affiliate of a taxpayer, that begin or end after various specified dates. However, where a taxpayer so elects in writing and files the “Global Section 95 Election” with the Minister of National Revenue before the taxpayer’s filing due-date for the taxpayer’s taxation year that includes the day on which these amendments are assented to, all of those measures apply to taxation years of all foreign affiliates, of the taxpayer, that begin after 1994.

The Joint Committee supports the proposal to provide taxpayers with an opportunity to elect to have certain of the amendments to section 95 and to Regulation 5907 apply on a retroactive basis. We believe, subject to the comments contained in this submission, that these proposed amendments clarify a number of the provisions and “fix” some of the unintended consequences that arose primarily as a result of the substantial changes to these rules that occurred with the enactment of Bill C-70 in June 1995.

It is our understanding that the Department tries to ensure that amendments to the Act will not apply retroactively unless the provisions in questions are relieving in nature. In these circumstances, retroactive application is justified because none of the proposed amendments represent a change in tax policy, but rather are intended to relieve taxpayers from being taxable in circumstances that were clearly not intended when the relevant provisions were introduced or amended as a result of Bill C-70.

However, for several reasons, we submit that the election in relation to the proposed amendments should not be on an all or nothing basis.

First, the proposed amendments eligible for the Global Section 95 Election are generally designed to deal with very specific issues and with diverse fact patterns. For example, one of the proposed amendments will resolve an issue that arises where a foreign affiliate that carries on an investment business disposes of eligible capital property that was used to earn deemed active business income,[45] while another proposed amendment deals with a completely unrelated issue flowing from the application of the deemed active business income rules in the context of inter-affiliate financing where one of the relevant foreign affiliates is a flow-through entity such as a U.S. limited liability company.[46] There does not appear to be any reason to group together these proposed amendments when the only commonality among them is that they are part of the regime found in subdivision i.

Second, two taxpayers in respect of the same fact pattern could be treated differently as a result of the election being on an all or nothing basis. Such a result could, for example, arise where the business activities of a foreign affiliate of one taxpayer is more complex than those of another taxpayer. An example of this is provided below.

Third, taxpayers and CCRA may not be in a position to fully evaluate the impact if all the proposed amendments apply on a retroactive basis.

Fourth, while the proposed amendments are intended to be relieving, this may not always be the case for particular taxpayers. For example, paragraph (c) in the definition of "excluded property" in subsection 95(1) has been expanded to include more assets that earn deemed active business income and assets that would earn deemed active business income if the asset earned income. However, under paragraph (c), where such assets earn 95(2)(a) income, it is now required that all or substantially all (interpreted by CCRA to be 90% or more) of its income be 95(2)(a) income versus the previous requirement in paragraph (a) to be used principally (i.e., more than 50%) for the purpose of gaining or producing income from an active business. This could make the retroactive application of this provision unfavourable for certain taxpayers.

We understand that the Department is concerned that if taxpayers are free to elect which of the amendments can apply on a retroactive basis, it will effectively result in creating a number of different foreign affiliate and FAPI regimes and the Department is uncertain as to how various provisions will interact with each other. We do not believe that this would be a significant problem because it is unlikely that many taxpayers will need to have more than one or two, if any, of the amendments apply on a retroactive basis. Indeed, it is possible that the present proposal will force many more taxpayers to make the Election on the belief that all the retroactive changes will be favourable but they may not have the time or the resources to establish if that is in fact the case.

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[45] See proposed subparagraph 95(2)(a)(v).

[46] See the proposed amendment to subclause 95(2)(a)(ii)(D)(V) to accommodate a *third affiliate* where the affiliate is not subject to income taxation in its country of residence but all or substantially all of the income earned by the affiliate is included in computing the income of the members of shareholders of the affiliate and is subject to income taxation in that country under the laws of that country.

Accordingly, with respect to the Global Section 95 Election, the Committee notes the following recommendations:

(i) The proposal that all of the proposed amendments subject to the Global Section 95 Election to be applied retroactively if a taxpayer so elects should be withdrawn. Rather, a taxpayer should have the ability to elect separately for each of such amendments that it wishes to apply retroactively to taxation years of all of its foreign affiliates that begin after 1994.

(ii) As a minimum, we suggest that certain amendments be excluded from the Global Section 95 Election and, instead, taxpayers would be able to elect separately for each of these amendments to apply on a retroactive basis to taxation years of all of its affiliates that begin after 1994, because such amendments arguably stand on their own. Such amendments should include the following:

- the proposed changes to clause 95(2)(a)(ii)(D)
- proposed paragraph 95(2)(n), which facilitates the application of clause 95(2)(a)(ii)(D) where the lending affiliate and the "second" and "third" affiliate are held through related but separate Canadian chains of companies
- the proposed change to description B in the definition of "foreign accrual property income", if this proposal is not withdrawn
- the changes to subsection 95(2.2)
- proposed subsections 95(2.21) to (2.23)
- proposed changes to subsections 95(2)(a.1) and proposed subsection 95(3.1)
- proposed changes to paragraph 95(2)(b) and subsection 95(3)

(iii) In addition, if the Global Section 95 Election is maintained, even with the above exclusions, taxpayers should be permitted, as of right, to revoke the election, on a global basis, if it turns out that making the election has placed the taxpayer at a disadvantage relative to its tax position had no such election been made. Moreover, taxpayers should be permitted to revoke the election, on a selective basis, with discretionary ministerial approval, to be given based on fairness principles.

In this regard, we suggest an amendment to subsection 220(3.2) and/or the regulations relating thereto, and that the Department provide guidance in the Explanatory Notes as to the type of circumstances that would give rise to such relief. It is submitted that such circumstances could include the following:

- Where the election gives rise to unequal results. Consider the following example:

  Taxpayer X owns all of the shares of a foreign affiliate ("FAX") and Taxpayer Y owns all of the shares of a foreign affiliate ("FAY"). Both FAX and FAY carry on an investment business and earned FAPI of $100 in 2000 as a result of the disposition of eligible capital property that was used to earn deemed active business income. Taxpayers X and Y reported FAX's and FAY's FAPI under subsection 91(1) and both taxpayers wish to take advantage of the proposed amendment that will exclude such amounts from FAPI by filing a retroactive election.

  Taxpayer X elects retroactive application, thereby removing the $100 originally reported under subsection 91(1) in computing its income for tax purposes in 2000 generating a tax refund of $50 (assuming a 50% tax rate for illustrative purposes). Taxpayer Y elects retroactive application to remove the same $100 from its income in 2000 but receives a tax refund of only $25.

  It turns out that, in 1995, FAY earned FAPI of $100 in respect of interest income from the investment of excess funds and realized a $50 allowable capital loss on the hedging of inter-affiliate debt. Following the provisions of the Act and CCRA technical interpretations and assessing practice at the time, Taxpayer Y included $50 ($100 interest income less $50 hedging loss) in computing its income under subsection 91(1). By making the retroactive election, Taxpayer Y has incurred a cost of $25 relative to Taxpayer X because the retroactive election has resulted in another of the proposed amendments applying to eliminate the foreign accrual property loss in respect of the hedge. In effect, Taxpayer X has a cost equal to the impact of another proposed amendment that is not relieving in its circumstances.

  It seems inappropriate and unfair that one taxpayer incurs a cost in making the election while another does not.

- Where taxpayers may not be in a position to fully evaluate the impact of the election if all the proposed amendments apply on a retroactive basis. Taxpayers will be required to review and analyze information for each taxation year beginning after 1994 for each of their foreign affiliates to determine the impact of each retroactive application. For taxpayers with a significant number of foreign affiliates, such an analysis may be an extremely complicated and time-consuming process. Difficulties may arise where the taxpayer no longer owns shares in a particular foreign affiliate and therefore, there is no access to information relevant for determining whether the taxpayer can or should take advantage of a particular technical amendment. As well, by the time the FA Proposals are revised and final legislation is released (assuming this is sometime mid to late 2003), many taxpayers may not have the time to fully analyze whether the Election should be filed before the Election is due.
  Perhaps more importantly, even where taxpayers do elect to have one of the proposed amendments apply on a retroactive basis so that all the changes apply on a retroactive basis, it could be extremely difficult for CCRA to audit or verify the proper application of the numerous proposed amendments given the number of years that have transpired since 1994 and the number of foreign affiliates that a particular taxpayer may have. In order to preserve the integrity and fairness of the Canadian tax system, the Committee believes it is necessary that taxpayers be able to comply with the rules and that the CCRA be in a position to enforce them. This is not likely to be the case if all of the proposed amendments subject to the Election are to apply to taxpayers on a retroactive basis.

(iv) There are certain inconsistencies in the coming into force provisions applicable to amendments to the Act and those applicable to corresponding amendments to the Regulations. We recommend that these inconsistencies be eliminated and note the following:

- With respect to the changes to the Act introducing the concept of a "qualifying member" of a partnership, making the Global Section 95 Election would result in these changes having effect for taxation years that begin after 1994. However, such an election would not result in the corresponding changes to the Regulations having effect for taxation years that begin after 1994. Rather, the FA Proposals provide that these changes would have effect only for taxation years that end after 1999.

- Thus, for taxation years that begin after 1994, and end before 2000, an inconsistent regime would be applicable. For those years,[47] clauses (d)(ii)(D), (F) and (G) of the definition of "exempt earnings" and (c)(ii)(D), (F) and (G) definition of "exempt loss" in Regulation 5907(1) would continue to rely on the "specified member" concept, except that this concept would be read without reference to paragraph (a) of that definition in subsection 248(1).
- The result would be that income that does not qualify for inclusion in exempt earnings because of this coming into force rule would be included in taxable earnings. This result is inappropriate, because this type of change (i.e., read "specified member" without reference to paragraph (a)) was the first solution proposed by the Department of Finance to address the concerns which had been raised, and it was determined that this solution was inadequate, and it was then announced that another solution would be developed. Then, based on further review, the "qualifying member" concept was developed, and it became known that taxpayers would be permitted to elect to have this measure take effect after 1994. There was no indication that this retroactive election would be restricted to the provisions of the Act, and would not fully extend to corresponding provisions of the Regulations.

(v) Finally, we recommend that the Department should extend the proposed due date for filing the election to the filing-due date for the taxpayer's taxation year following the year that includes the day on which these amendments are assented to.

B. Fresh Start Section 95 Election

We have also identified a number of concerns that arise in connection with the fresh start rules, and with the Fresh Start Section 95 Election. These are described above in the section of this Report that addresses the fresh start rules.

[47] Actually, the exception to the retroactive to 1995 coming into force rule in paragraphs 6(a) to (d) of the draft Regulations in the Technical Bill refers to all taxation years that end before 2000. This would technically seem to include years before 1995.