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October 19, 2011

Mr. Brian Ernewein
General Director
Tax Policy Branch
Department of Finance
L'Esplanade Laurier, East Tower
140 O'Connor Street
Ottawa ON K1A 0G5

Dear Mr. Ernewein:

Re: August 19, 2011 Amendments Regarding the Taxation of Foreign Affiliates

On behalf of PricewaterhouseCoopers LLP ("PwC"), we are pleased to present our comments on the August 19, 2011 amendments regarding the taxation of foreign affiliates ("August 19 Amendments" or "the Amendments") in the attached Appendix.

Overview

The August 19 Amendments includes revisions to the foreign affiliate reorganization and distribution rules proposed in a February 27, 2004 release, which followed an initial release on December 20, 2002. The Amendments also include new proposals in place of certain of the 2004 proposals which, for the purposes of the surplus accounting rules, proposed to suspend gains arising on certain internal transactions and reorganizations involving the sale of shares and other assets of foreign affiliates.

Our recommendations in this submission are directed at clarifying the tax policy underlying the August 19 Amendments so that their enactment will enhance the efficiency and fairness of Canada's foreign affiliate system while reducing the compliance and the administrative and enforcement burden on taxpayers and the Canada Revenue Agency ("the CRA") and minimizing the disruption to normal business operations of Canadian companies carrying on active businesses outside of Canada.

In this regard, the Minister and the Department of Finance ("Finance") should be commended for abandoning a number of the February 2004 proposals, in particular, the numerous

proposals dealing with the so-called gain suspension rules, including certain promised changes that were announced after the release of the 2004 proposals. PwC had written and spoken previously to Finance officials about the enormous compliance and administrative burden and cost these proposals would have imposed on taxpayers and the CRA. The revised and more simplified approach adopted in the August 19 Amendments to maintain the integrity of the current foreign affiliate system is welcomed by taxpayers and, we expect, the CRA.

Looking Ahead – Enhancing Canada's International Tax Advantage

Enacting Other Promised Changes

The August 19 Amendments include a number of technical changes that were promised by Finance in comfort letters after the release of the 2004 proposals. The enactment of these changes is welcomed by taxpayers. However, there are a number of other promised changes outstanding that will further simplify compliance and administration and improve the overall efficiency and fairness of the foreign affiliate system. PwC strongly urges Finance to enact these promises as soon as possible.

The Advisory Panel on Canada's System of International Taxation (the "Panel")

In its press release of the August 19 Amendments, the Government indicated that it "remains committed to continuing its review and analysis of all of the Panel's recommendations and consideration of further legislative developments."

PwC strongly urges the Government to complete its review and analysis of the Panel's recommendations as soon as possible. PwC also urges the Government to be more open and transparent in its review of the Panel's recommendations so that it can benefit from a broader consultation with the tax community to ensure the international tax system enhances Canada's international tax advantage, minimizes compliance costs for taxpayers and facilitates the administration and enforcement by the CRA.

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We appreciate having the opportunity to submit our comments and would be pleased to discuss them further with you or your staff at your convenience.

Please feel free to contact any of us as noted below.

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Yours truly,

PricewaterhouseCoopers LLP

c.c. Nancy Horsman, Department of Finance
Gérard Lalonde, Department of Finance
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Appendix

PricewaterhouseCoopers LLP Submission – The August 19, 2011 Amendments Regarding the Taxation of Foreign Affiliates

All statutory references are to the *Income Tax Act* ("Act") unless otherwise stated.

1. Upstream Loans

Modelled after subsection 15(2), subsections 90(4) to (10) require an income inclusion in respect of loans to a "specified debtor" from a foreign affiliate of the taxpayer. A specified debtor includes the taxpayer, a person with whom the taxpayer does not deal at arm's length (other than a controlled foreign affiliate within the meaning of section 17), and certain partnerships.

If an amount in respect of a loan is included in income in a particular year, a "reserve" deduction is available in that same year if all three conditions in paragraphs 90(6)(a) to (c) are met.

The Explanatory Notes indicate that the upstream loan proposal was introduced "to protect the integrity of the existing taxable surplus and the new hybrid surplus regimes", as well as stating it was "designed to prevent taxpayers from making synthetic dividend distributions from foreign affiliates in order to avoid what would otherwise be income inclusions under new subsection 90(1) that are not fully offset by deductions under paragraphs 113(1)(a) to (b)." However, the rules as currently drafted can result in an income inclusion for a taxpayer where no such taxable surplus or hybrid surplus exists.

In addition, regulation 5901(2)(b) allows taxpayers to "side-step" the normal ordering rules of regulation 5901(1) with respect to actual dividend distributions and instead have a dividend deemed to be paid out of pre-acquisition surplus, thus allowing taxpayers who receive dividends to defer a taxable surplus or hybrid surplus inclusion to the extent of available cost base on foreign affiliate shares. As described below, there is no comparable relief in the case of upstream loans and it is not clear why such relief should not be available from a tax policy perspective.

1.1 Paragraph 90(6)(a) – access to tax attributes other than surplus

Paragraph 90(6)(a) provides a deduction in respect of the specified amount included in the taxpayer's income, to the extent that the taxpayer could, had the amount been paid up the chain to the taxpayer as a dividend or a series of dividends, claim a full deduction on account of available exempt surplus, hybrid surplus, or grossed up deduction in respect of taxable surplus. No deduction is available for other tax attributes such as the tax basis in the shares of

the top tier foreign affiliate or in downstream loans, and previously taxed foreign accrual property income ("FAPI").

Tax basis in foreign affiliate shares

The denied access to the cost base in the top tier foreign affiliate shares will prevent repatriation of capital invested in foreign affiliates which in our view is beyond the stated purpose of the upstream loan rule. Taxpayers should be free to repatriate capital invested in foreign affiliates in any legal form as they deem appropriate, particularly in situations where a foreign affiliate is restricted from paying a dividend or in many jurisdictions a legal return of capital is a costly and time consuming process.

As an example, Canco may own a foreign affiliate ("FA") that generates significant cash earnings from its active business but does not have any surplus due to accelerated tax deductions under the local tax law that is relevant in determining the particular FA's surplus. A loan from such FA to Canco should not result in an income inclusion provided there is sufficient adjusted cost base ("ACB") in the FA's shares, since the loan is not used to defer tax on repatriation of the FA's taxable surplus or hybrid surplus. Even if the FA had taxable surplus, we do not believe Canco should be taxed on the amount of the loan, as Canco could otherwise make a pre-acquisition surplus dividend election under regulation 5901(2)(b) had the FA been able to make a cash distribution.

There are other situations where an FA may have available cash to repatriate but no surplus. For example, if the FA shares have been bumped under paragraph 88(1)(d) on a windup or vertical amalgamation, regulation 5905(5.12) of the August 27, 2010 proposals, applicable to an acquisition of control that occurs before December 19, 2009, would reduce to nil the surplus balances of the FA and lower tier affiliates that accrue prior to the acquisition of control. For an acquisition of control that occurs after December 18, 2009, regulation 5905(5.2) of the August 27, 2010 proposals also has the effect of resetting the combined surplus balances of the FA and lower tier affiliates to nil if Canco's ACB in the FA shares exceeds their value at the time of the acquisition of control.

In addition, the source of the funds for the loan may have originated from Canada. For example, a Canco wholly owned by a foreign multinational corporation ("FMNC") may have excess cash which FMNC wishes to redeploy to other foreign subsidiaries owed by FMNC. In this example, Canco contemplates paying a dividend to FMNC. However, such dividend may trigger adverse foreign tax consequences. In addition, a loan made by Canco to FMNC or a subsidiary of FMNC (that is not a foreign affiliate of Canco) that is not repaid within one year after the end of the taxation year in which it arose would trigger the application of subsection 15(2). In such situations, based on rulings and technical interpretations issued by the CRA, Canco may choose to form a new foreign affiliate, Finco, and subscribe for shares of Finco using its excess cash. Finco will use the cash received to make a loan to FMNC or a

subsidiary of FMNC under arm's length terms and conditions. Interest income on such loan would be included in Canco's income as FAPI.

A loan from Finco should not result in a net income inclusion provided there is sufficient ACB in the shares of Finco, since the loan is not used to defer tax on repatriation of Finco's taxable surplus or hybrid surplus. In addition, given that the source of the funds for the loan made by Finco originated with Canco, generated through the accumulation of after tax profits of Canco, the inclusion of such a loan in Canco's income is contrary to the policy of subsection 248(28), which provides that no provision of the Act should require the inclusion of an amount in income to the extent that the amount has already been directly or indirectly included in income. Finally, although not stated as the policy intent behind the upstream loan proposals, we do not believe that from a tax policy point of view the cost basis denial should be driven by a possible perceived abuse of subsection 15(2) with respect to loans to non-resident persons related to Canco. In our view, the general anti-avoidance rule should suffice in this regard.

"Downstream" loans and other tax attributes

In the preceding example, instead of capitalizing Finco with equity, Canco could make an interest-bearing loan (with arm's length terms) to Finco. The interest earned from Finco is included in Canco's income, and the net income of Finco is also included in Canco's income as FAPI. Similar to the comment above, a loan from Finco should not result in an income inclusion provided there is sufficient ACB in the loan to Finco, since the loan is not used to defer tax on repatriation of Finco's taxable surplus or hybrid surplus and the source of the loan originated with funds provided by Canco.

There may be other cases where the source of funds for a loan provided by a foreign affiliate did not originate with a Canadian taxpayer but the purpose of the loan was not to defer tax on the repatriation of taxable surplus or hybrid surplus. For example, assume that Canco is a subsidiary of FMNC. Canco owns a foreign affiliate ("FA") that carries on an active business that generates exempt earnings. FA pays regular dividends to Canco and as a result, FA's surplus balances in respect of Canco are nil. Canco has only a nominal ACB in respect of its shares of FA. Due to its strong earnings potential and asset value, FA is able to borrow from a third party bank in order to provide interest-bearing loans with arm's length terms and conditions to other subsidiaries of FMNC that are not controlled foreign affiliates of Canco as defined under subsection 17(15). The interest received by FA in excess of the interest paid to the bank should be FAPI. Similar to the comments above, a loan from FA should not result in an income inclusion since the loan is not used to defer tax on repatriation of FA's taxable surplus or hybrid surplus.

Previously taxed FAPI

FAPI earned by a controlled foreign affiliate and included in a taxpayer's income is added to the taxpayer's ACB in the affiliate shares if held by the taxpayer or in the shares of the top tier

affiliate in the chain above the controlled foreign affiliate. A dividend paid to the taxpayer out of current and prior years' FAPI can be received tax-free as a consequence of the subsection 91(5) deduction.

Taxpayers should therefore be able to borrow funds out of current and prior years' FAPI earnings.

Submission

Paragraph 90(6)(a) should be expanded to include paragraph 113(1)(d) and subsection 91(5) deductions. In the case of deductions under paragraph 113(1)(d), consideration should be given as to what "restrictions" would need to apply to ensure tax basis is not "duplicated" when used in other transactions provided that such restrictions are commercially reasonable.

Secondly, relief should be provided for any ACB in "downstream loans" made to relevant foreign affiliates in the chain.

Thirdly, consideration should also be given to limiting the scope of the inclusion in respect of an "upstream loan" to cases where had the foreign affiliate otherwise paid a dividend equal to the amount of the loan, all or a portion of the dividend would have been considered paid out of taxable surplus or hybrid surplus with insufficient underlying foreign tax.

1.2 Paragraph 90(6)(b) – hypothetical dividends and deductions

Elections

Under paragraph 90(6)(a) is the concept of hypothetical dividend(s) paid up the chain to a Canco, as well as hypothetical deductions under paragraphs 113(1)(a) to (b). It is not clear, when applying these hypothetical concepts, whether certain elections can be taken into account.

For example, if an actual taxable surplus dividend is paid to Canco it can make an election to attach a disproportionate amount of underlying foreign tax to the dividend received. For purposes of paragraph 90(6)(b) it would make sense that such election should be taken into account.

In the case of an actual dividend paid to Canco which results in a subsection 40(3) gain, Canco can make a subsection 93(1) election to access available surplus in foreign affiliates below the dividend paying affiliate. If the affiliate makes a loan to Canco, in considering the hypothetical dividend and deductions, it is not clear whether a hypothetical subsection 93(1) election is considered made by Canco so that lower tier surplus balances can be used to support the loan amount.

If a loan is made by a lower tier affiliate, and a hypothetical dividend results in a subsection 40(3) gain on the shares of that affiliate, it appears that the automatic subsection 93(1.1) election would apply to levitate, to the extent of the gain, the surplus of those affiliates below the lender affiliate. In this case it seems that the surplus below the lender affiliate is available to support the upstream loan amount, but only in situations where there is low or no ACB in the shares of the lender affiliate.

90-Day and current year earnings

Based on the current wording of the provision it appears that if a loan is made after the first 90 days of the taxation year of the lending affiliate, its earnings for the year in which the loan is made can be used to support the loan amount. This interpretation is consistent with the hypothetical dividend and deductions concept of the provision.

Submission

Clarification of the above concerns is needed to avoid any interpretive issues by taxpayers and the CRA.

With respect to the ability to access surplus of affiliates below the lending affiliate, it should be irrelevant whether or not there is a subsection 40(3) gain or whether the gain is realized at the Canco or the foreign affiliate level. Since the income inclusion under subsection 90(4) is based, in part, on the taxpayer's surplus entitlement percentage ("SEP") in the lending affiliate, implicitly the surplus balances of lower tier affiliates are taken into consideration as such surplus is relevant in determining the SEP, i.e. the lower tier surplus balances are notionally deemed distributed up the chain for SEP purposes in the case where there are multiple classes of shares such that SEP is not determined based on equity percentage. To be consistent, the surplus in the lower tier foreign affiliates should be included in determining the surplus available to support the loan.

1.3 Paragraph 90(6)(b) – no dividends can be paid while loan is outstanding

Paragraph 90(6)(b) requires that while a loan is outstanding no dividends are paid to the taxpayer or non-arm's length resident persons by the lending foreign affiliate or any foreign affiliate in the chain above it in order to be able to reduce the income inclusion by available surplus. This restriction applies even if there is sufficient surplus in the chain to cover the dividends and the loan amount. Furthermore, because all pro-rata distributions are deemed to be dividends for purposes of the Act, a legal return of capital is also prohibited.

Paragraph 90(6)(b) effectively forces taxpayers to choose to either make loans or pay dividends, but not a combination thereof. This will affect repatriation of funds and cash management for affiliates in the chain above and below the lending affiliate. For example, consider a Canco that generates a significant majority of its cash flow and income outside of

Canada through wholly-owned foreign affiliates. Canco regularly needs cash to fund the payment of interest expense and dividend. A significant source of Canco's cash comes from its foreign affiliates. Due to the fact that dividends from certain foreign affiliates cannot occur in a timely manner (for example, in some jurisdictions audits are required before a dividend can be paid which means a dividend is usually only paid once a year after year-end), Canco would typically borrow from its foreign affiliates and these loans are subsequently repaid in the following year once the lender affiliate pays a dividend to Canco. Given the uncertainty that such loans and repayments could be viewed as a "series of loans....and repayments" for purposes of paragraph 90(5)(b), Canco would prefer to rely on the subsection 90(6) deduction. However this deduction will not be available because dividends are paid to Canco. As a result, the requirement in paragraph 90(6)(b) could cause higher financing costs for Canadian companies if they are restricted from managing their cash efficiently.

In addition, the restriction in paragraph 90(6)(b) would appear to preclude a taxpayer from making a subsection 93(1) election. For example, assume a Canco owns 100% of FA1 which owns 100% of FA2, FA1 has no net surplus and FA2 has net surplus and exempt surplus of $500, and FA2 has made a $100 loan to Canco. Canco then redeems 10% of its shares in FA1 and realizes a $40 capital gain. If Canco makes a subsection 93(1) election to reduce its proceeds by $40 and treat the $40 as a dividend paid out of FA1's exempt surplus, then the subsection 90(6) deduction would not be available to Canco in respect of the upstream loan received from FA2 because of the restriction in paragraph 90(6)(b).

Submission

Dividends should be allowed provided there is sufficient exempt surplus, taxable surplus or hybrid surplus with sufficient underlying foreign tax to cover both the dividends and the portion of the loan amount included in income.

1.4 Loans to foreign affiliates not controlled by Canada

Back to back loan situations may give rise to multiple income inclusions due to the fact that the definition of specified amount is determined based on the taxpayer's SEP in the lending affiliate. Consider a situation where Canco owns a group of foreign affiliates not controlled by Canco but by Canco's foreign parent. Within the foreign affiliate group is a company that operates as a treasury center, which borrows from group companies with excess cash and lends to others in the group with cash needs. In this case, both the loans from the excess cash affiliates and the treasury affiliate are caught because the borrowing entities are not controlled foreign affiliates of Canco within the meaning of subsection 17; and, assuming there is no available surplus, Canco is required to include in income an amount equal to its SEP in each relevant affiliate times the principal of each loan. This is clearly not within the policy intent of the upstream loan rule.

Even in non back to back situations, loans between non-controlled foreign affiliates should not, in our view, be subject to subsection 90(4) because these loans are not disguised distributions back to Canco. The funds remain offshore and thus should be allowed to move freely within the group.

Even if the above multiple income inclusions anomaly were resolved, there is still a concern that Canco is now required to track the loan amounts and their repayments. In a large group of companies where there is a significant volume of cash flow activities as funds are swept into and out of the treasury company on a daily basis, it will be impractical or impossible for Canco to determine its compliance with the upstream loan rule.

Submission

Loans between non-controlled foreign affiliates that are held by Canco (or non-arm's length resident persons) should not be subject to subsection 90(4) to the extent that Canco's surplus entitlement percentage in the borrower affiliate is not less than the surplus entitlement percentage in the lender affiliate.

1.5 Partnership as taxpayers

Extended definition of controlled foreign affiliate and subsection 113(1) deductions

The exception for loans made to Canadian controlled foreign affiliates do not work properly in situations where loans are made by a foreign affiliate of a partnership to a foreign affiliate of the group not held by the partnership. This is due to the fact that the extended definition of controlled foreign affiliate in subsection 17(13) only applies to corporate taxpayers.

To illustrate, assume Canco, together with its Canadian subsidiary Cansub, own 100% of the partnership interests in a partnership P which owns 100% of a foreign affiliate Finco. Canco also owns, not through P, 100% of a separate group of foreign affiliates. A loan from Finco to an affiliate held under Canco would not be exempt because the borrowing affiliate is not a controlled foreign affiliate of P, and thus P is required to include in its income the amount of the loan. If P were a Canadian corporation the loan would be exempt as the borrowing affiliate would be considered a controlled foreign affiliate of that corporation by virtue of subsection 17(13).

Furthermore, the paragraph 113(1)(a) to (b) deductions provided in paragraph 90(6)(a) are not available to P because those provisions are applicable only to corporate taxpayers. P is only deemed to be a corporation solely for purposes of determining its SEP in Finco, as provided in letter B in the definition of "specified amount" in subsection 90(10).

Double income inclusion

Subsection 90(4) applies if a foreign affiliate of the taxpayer makes a loan to a specified debtor. The amount included in the taxpayer's income is equal to the taxpayer's SEP in the foreign affiliate multiplied by the amount of the loan.

If Finco in the above example makes a loan to a non-controlled foreign affiliate or another related Canadian company, P is deemed to have an SEP in Finco, 100% in this case, and the loan amount is included in P's income under subsection 90(4) and allocated to Canco and Cansub.

Canco together with Cansub also have income inclusions under subsection 90(4) in respect of the same loan amount, because, as a result of the interaction of the following provisions, Finco is also a foreign affiliate in which each of these taxpayers has an SEP. Firstly, subsection 93.1(1) as amended is now relevant for purposes of section 90 and thus Finco is considered a foreign affiliate of Canco and Cansub. Secondly, SEP as defined in subsection 95(1) is prescribed in regulation 5905(13), and regulation 5908(1) of the August 27, 2010 proposal provides a partnership look through rule for various purposes in the regulations including regulation 5905. Accordingly each of Canco and Cansub would have an SEP in Finco.

Submission

The upstream loan rules need to be amended to operate as intended where a partnership that has Canadian resident corporations as members owns shares of a foreign affiliate.

1.6 Retrospective application to existing loans

The upstream loan rules apply to loans made after August 19, 2011. For loans that existed on August 19, 2011, the rules apply to the outstanding balance of those loans which are deemed made on August 19, 2011. Therefore taxpayers have two years from that date to unwind pre-existing loans.

As noted above, relying on rulings and technical interpretations issued by the CRA which endorsed upstream loans as a mean of repatriation, some taxpayers have made significant upstream loans from its foreign affiliates. Two years is not sufficient to allow taxpayers to unwind the loans and restructure their affairs as there are numerous implications to consider including foreign tax and commercial issues and/or constraints, cash flow considerations, and Canadian tax implications arising from settlement of loans that are not denominated in Canadian dollars. Issues may also arise where the terms of the loans do not provide for early repayments.

Besides upstream loans, there are many structures involving loans between foreign affiliates controlled by foreign parents of Canadian taxpayers. Many of these loan structures may have

been inherited when the Canadian taxpayers acquired their interests in the foreign affiliate group that had previously been wholly owned by the foreign parents. Unwinding these offshore loans may not be a simple process as foreign tax and commercial implications will again have to be considered.

Submission

We submit that pre-existing loans should be grandfathered, or at a minimum the two year period should be extended to allow taxpayers time to properly unwind their upstream loan structures.

With respect to inter-affiliate loans, the suggestions as described in 1.1 and 1.4 should eliminate the need to unwind the loans.

2. Pre-Acquisition Dividends / Partnerships

Subsection 90(2) will deem all distributions of a foreign affiliate of a taxpayer (other than a liquidating distribution or a distribution on a redemption, acquisition or cancellation of a share by the foreign affiliate) to be a dividend. This should prove to be a very helpful provision for taxpayers because it will remove the uncertainty concerning the characterization of distributions paid by a foreign affiliate from share premium, other capital account created under foreign commercial law or from contributed surplus.

Subsection 90(2) also implies that taxpayers will, generally, no longer be able to access the ACB in the shares of a foreign affiliate through a return of its legal capital. This is a substantial change in policy and is not consistent with the domestic context.

For corporate taxpayers, there is the entire regime of exempt, hybrid, and taxable surplus. A distribution treated as a dividend would tap into that regime with the Canadian tax consequences that follow. Furthermore, for corporate taxpayers regulation 5901(2)(b) provides an election to treat a distribution from a directly held foreign affiliate as paid out of the affiliate's pre-acquisition surplus. In this way, corporate taxpayers are provided with a way to access the ACB of the shares of a top-tier foreign affiliate. Non-corporate taxpayers: i.e., partnerships, trusts and natural persons, do not have access to the surplus regime. Proposed subsection 90(2) will result in all distributions from a foreign affiliate being fully taxable. Regrettably, there is no provision for non-corporate taxpayers to restore the ability to access the ACB in the shares of a foreign affiliate, comparable to regulation paragraph 5901(2)(b). Thus, these taxpayers will lose the ability, which they have had for decades, of returning the legal capital of a foreign affiliate on a tax-free (or more accurately, tax-deferred) basis.

It is not clear what the policy rationale for this fundamental change would be. Those most directly impacted are likely public partnerships and trusts which previously could access the paid-up capital of their foreign affiliates to provide a tax-efficient return to their investors. Commercially, the ability to return income to investors as a return of capital, to the extent of available ACB, is a significant feature of these public vehicles.

Submission

Finance should reconsider this particular aspect of subsection 90(2). At the very least, Finance should restore to non-corporate taxpayers the ability to access the paid-up capital of their foreign affiliates. This could be done quite simply by providing an exception within subsection 90(2) to maintain the status quo as far as non-corporate shareholders are concerned.

However, in our view, merely maintaining the status quo by carving non-corporate taxpayers from the purview of proposed subsection 90(2) is not sufficient. Under this approach, non-corporate tax payers would continue to be subject to the uncertainty concerning the nature of foreign affiliate distributions that proposed subsection 90(2) would otherwise have dealt with. Furthermore, non-corporate taxpayers would be disadvantaged, relative to corporate taxpayers, by not having access to the pre-acquisition surplus election in proposed paragraph 5901(2)(b) of the regulations. In light of these deficiencies, we recommend that subsection 90(2) be applicable to all taxpayers, as proposed, and that non-corporate taxpayers also have access to a modified version of the pre-acquisition surplus election.

We recommend that non-corporate taxpayers be given the ability to elect to treat a distribution from a foreign affiliate as if it were a return of capital. To prevent non-corporate taxpayers from converting income receipts to capital gains, the ability to make this election should be limited to the lesser of the ACB of the shares of a distributing foreign affiliate and the paid-up capital in respect of those shares. For this purpose, paid-up capital should include share premium, contributed surplus or other capital amount in respect of the issuance of shares or a shareholding. A new clause 53(2)(b)(i)(C) could be added to provide for a reduction in the ACB of the shares of a foreign affiliate in respect of which such an election has been made.

3. FAPL Streaming

Under the currently enacted definition of FAPI in subsection 95(1) allowable capital losses realized by a foreign affiliate on dispositions of non-excluded property are available to reduce the foreign affiliate's FAPI earnings from all sources, including earnings on income account. The proposals contain amendments to the definition of FAPI that will limit the deduction of such capital losses to the amount of current year capital gains realized on the disposition of non-excluded property.

In addition, allowable capital losses in excess of capital gains realized by a foreign affiliate in a given year on dispositions of non-excluded property are proposed to be included in the foreign affiliate's foreign accrual capital loss ("FACL") balance that will be tracked separately from the foreign affiliate's foreign accrual property loss ("FAPL") balance. The use of FACLs in a subsequent year to reduce a foreign affiliate's FAPI is proposed to be restricted to the excess of the capital gains over the allowable capital losses realized by the foreign affiliate on dispositions of non-excluded property in that subsequent year. It is further proposed that FACLs may be carried back 3 years and forward 20 years similar to FAPLs.

One of the guiding principles of the FAPI regime is that it operates to ensure a taxpayer is taxed in respect of certain income earned and gains realized by a foreign affiliate as if the taxpayer had undertaken the transactions giving rise to the income and/or gains directly. According to the Explanatory Notes, the above changes (referred to as the "FAPI loss streaming rules") are being made as "part of an initiative to bring the foreign affiliate FAPI rules in line with the rules applicable to Canadian corporations." While these FAPI loss streaming rules are consistent with the guiding principle set out above, we believe more should be done to ensure the FAPI regime operates efficiently and equitably – especially in the case of gains and losses realized on loans between foreign affiliates and Canadian taxpayers denominated in a different currency than the taxpayers' calculating currency where no economic gain or loss is in fact realized by the group.

In addition, we believe the proposed FAPI loss streaming rules represent a significant change in policy regarding the calculation of FAPI and, therefore, should apply prospectively to capital losses realized by a foreign affiliate after announcement date.

Submission

The FAPI rules should be amended to:

- Ensure capital gains realized by a foreign affiliate as a result of foreign exchange movements in respect of loans to or from a Canadian taxpayer retain their character as being realized on account of capital when included in the taxpayer's income for tax purposes. This would allow a taxpayer to reduce FAPI capital gains by the capital loss realized directly by the taxpayer on the settlement of the loan or indebtedness.

- Ensure capital losses realized by a foreign affiliate as a result of foreign exchange movements in respect of loans to or from a Canadian taxpayer retain their character and are transferred on a current basis to the taxpayer similar to FAPI. This would allow a taxpayer to offset foreign exchange capital gains realized directly on the settlement of the loan or indebtedness with the capital loss realized by the controlled foreign affiliate on the settlement of the same loan or indebtedness.

The coming-in-to-force rules for the proposed FAPI loss streaming rules referred to above should be amended to only apply to dispositions of non-excluded property occurring after announcement date.

4. Stop Loss – Subsection 93(2)

The stop loss rules in subsection 93(2) (and also related provisions in subsections 93(2.01), 93(2.11), 93(2.21) and 93(2.31)) have been amended to allow for the recognition of the portion of a loss on a share of a foreign affiliate that relates to a foreign exchange gain realized on the settlement of a hedge.

In order for the hedge gain to be eligible to restore the loss on the shares, four conditions relating to the hedge need to be met. Those conditions are:

(i) The foreign exchange gain on the hedge must be realized within 30 days before or after the foreign affiliate shares are disposed.

(ii) The hedge must be entered into within 30 days before or after the day the foreign affiliate shares are acquired.

(iii) The foreign exchange gain on the hedge must not be covered by an offsetting loss under another hedge entered into with an arm's length person.

(iv) The hedge must be with an arm's length persons.

The first condition attempts to link the disposition of the hedge to the disposition of the shares by requiring that the hedge be realized within a period 30 days before or 30 days after the disposition of the foreign affiliates shares.

Having to dispose of the hedge at approximately the same time as the foreign affiliate shares assumes that a taxpayer is able to predict the time of disposition of the shares in order to be able to enter into a hedge with a term that would match, within the prescribed time period, the disposition of the shares. Being able to predict the timing of the disposition of the shares within such limits is not often possible especially where the shares are held long term.

The second condition attempts to link the hedge to the acquisition of the shares by requiring that the hedge be entered into either 30 days before or 30 days after the acquisition of the foreign affiliate shares.

Having to acquire the hedge at approximately the same time as the foreign affiliate shares, means that the hedge cannot be replaced or rolled over to a similar hedge during the period that the foreign affiliate shares are held. Again this requires that the term of the hedge must

match the term (within 30 days) the foreign affiliates shares are held. Since most foreign affiliate share investments are not short term, it follows that any hedge would need to be long term and, as a result of condition 1) above, need to be settled within the 30 day period that matches the date of disposition of the foreign affiliate shares.

Such constraints would not be practical for derivatives as generally forward exchange contracts are for less than one year. Contracts that are greater than one year are not common in the market. Generally the conditions in 1) and 2) above would limit the hedge to term debt where the date of disposition of the foreign affiliate shares was the date (within 30 days) that the debt matured. Therefore the conditions significantly limit the taxpayer in their choice of a hedge.

Submission

In order to maintain the same conditions but allow for some flexibility, we recommend that an election be added to the provision to allow a taxpayer to elect to realize the accrued loss on the foreign affiliate shares to match a gain realized on the settlement of the hedge. Under these circumstances a taxpayer could use a hedge that was settled prior to the disposition of the foreign affiliate shares and if the taxpayer so chose, re-enter into a new hedge. Presumably a provision would also need to be added to deem the new hedge to be the same as the old hedge.

Another recommendation to provide for some additional flexibility is to allow a substitution of foreign affiliate shares where the substituted shares acquired were pursuant to a rollover rule in either subsection 85.1(3), subsection 51(1), or subsection 86(1). Such a rule would allow certain reorganizations to take place without the losing the ability to offset a gain on the hedge.

The fourth condition noted above requires that the hedge be with an arm's length person. Often a Canadian taxpayer may establish a separate legal entity to hold its foreign affiliate investments. This condition precludes having another related entity, such as the parent, enter into a loan agreement or hedging arrangement with a third party and then having a mirror agreement with the Canadian subsidiary to provide the hedge. Such arrangements may be necessary under banking agreements or covenants. As a result we recommend eliminating the fourth condition.

Lastly we recommend that an ordering rule be considered for the application of subsection 93(2) relative to other stop loss rules in the Act. For example, it is our understanding that a taxpayer would first compute its loss under subsection 93(2) before applying other stop loss rules such as subsection 40(3.3) and (3.4). Therefore once the loss under subsection 93(2) has been determined, the rules in subsection 40(3.3) and (3.4) would apply to suspend the loss. However without an ordering rule, it is unclear whether subsections 40(3.3) and (3.4) should apply first to suspend the loss before applying subsection 93(2). In addition, for the same

reasons, we recommend adding to the ordering rule that subsection 93(2) applies prior to subsection 93(4) and subsection 40(3.6).

5. Surplus Anti-Avoidance / Surplus Reclassification Rule

Regulation 5907(2.02) contains a surplus reclassification rule, which can apply to effectively reclassify exempt surplus as taxable surplus where the increase in exempt earnings (or the decrease in exempt loss) arises from a "transaction" that is an "avoidance transaction", as such terms are defined in subsection 245(1). In the overview section of the Explanatory Notes, the purpose of this new rule is stated as follows:

> *This new rule replaces a suspension regime in respect of certain internal transfers of property (other than foreign affiliate shares) that was proposed as part of the 2004 Proposals.*

The Explanatory Notes to regulation 5907(2.02) also indicate that this measure is intended to target "tax-motivated" transactions designed to increase exempt earnings and incorporates the standards of the general anti-avoidance rule in section 245 (the "GAAR"), rather than creating a specific set of avoidance standards.

We believe that the scope of regulation 5907(2.02) is too far-reaching for the following reasons:

(i) Not Limited to Surplus Arising on Internal Property Transfers: The Explanatory Notes state that the surplus reclassification rule is intended to replace the surplus suspension rules for internal property transfers, other than transfers of shares. We understand that the specific rules in mind were paragraphs 95(2)(f.4) to (f.9) of the 2004 Proposals. These rules were expressly limited to internal dispositions of excluded property, other than shares, and subparagraph 95(2)(f.6)(ii) of the 2004 Proposals also ensured the rules did not apply to property disposed of in the ordinary course of business or as an adventure or concern in the nature of trade.

In contrast, regulation 5907(2.02) applies in respect of a "transaction" that gives rise to "exempt earnings". For this purpose, a "transaction" includes an arrangement or event, as per the definition in subsection 245(1), and thus could include a disposition of property, the advance of a loan, the payment of an amount owing and potentially even the filing of an election. In addition, while exempt earnings includes gains from internal dispositions of excluded property other than shares, it also includes gains from external dispositions of excluded property other than shares, the non-taxable portion of capital gains included in FAPI, active business income and income recharacterized as active business income under paragraph 95(2)(a). The use of the inclusive definition of "transaction" in subsection 245(1) in combination with the "exempt earnings"

definition significantly expands the potential application of regulation 5907(2.02) beyond its stated purpose.

(ii) Rule Could Be Triggered by Non-Surplus Motivated Transactions: Regulation 5907(2.02) provides, in part, as follows:

> *...the amount or portion arises from a transaction...that is, or would be (if the amount or portion were a tax benefit for the purposes of section 245 of the Act), an avoidance transaction...*

The provision could be read such that it applies to an increase in exempt earnings that arises from either: (i) a transaction that is an avoidance transaction, or (ii) a transaction that would be (if the amount or portion were a tax benefit for the purposes of section 245) an avoidance transaction. Since the words in the parenthetical only seem to modify the "would be" test, it is possible that the rule could apply in respect of transactions motivated by tax considerations other than surplus.

For example, consider a standard loss utilization transaction. FA1 owns a capital property that is not excluded property and also has a FACL that is about to expire. In order to use the FACL, FA1 transfers the capital property to FA2 and realizes a FAPI gain and the non-taxable portion of the gain is included in exempt earnings. In this scenario, the transaction may be an avoidance transaction by virtue of the loss planning and the addition to exempt earnings merely arises by virtue of the normal operation of the surplus rules. Although the loss utilization transaction may be an avoidance transaction, this should be acceptable under the GAAR by virtue of the saving provision in subsection 245(4). Notwithstanding, regulation 5907(2.02) could apply to reclassify the surplus.

(iii) No Saving Provision: Although the "transaction" and the "avoidance transaction" concepts from the GAAR are adopted in regulation 5907(2.02), the "misuse or abuse" exception in subsection 245(4) is not applicable. In fact, the Explanatory Notes state that an increase in exempt earnings that is tax motivated *will be considered to be abusive*. The definitions of "transaction" and "avoidance transaction" in subsection 245(1) are broad and the exception in subsection 245(4) was intended to temper the scope of the GAAR in recognition of the principle that certain forms of tax planning are acceptable.

Without a similar saving provision in regulation 5907(2.02), we are concerned that the rule could unintentionally apply to a considerable range of transactions that otherwise seem to be permitted under the Act. The degree of specificity and complexity of the foreign affiliate regime means that Canadian tax planning is often required to navigate the rules. In other words, some degree of "tax motive" may be present in many foreign affiliate transactions that do not otherwise result in a misuse or abuse of the Act.

In addition, if regulation 5907(2.02) applies, the amount that would otherwise have been added to exempt earnings is instead added to taxable earnings. Unlike the 2004 Proposals, exempt surplus treatment is not merely deferred until the property is disposed of to a third party, it is denied entirely. It is not clear why this result has been adopted, as it seems to be inconsistent with both the treatment of surplus on dispositions of shares and partnership interests subject to the hybrid surplus rules and the GAAR. Where the GAAR applies, subsection 245(5) stipulates that the tax consequences are to be determine "as is reasonable in the circumstances" to deny the tax benefit. If, for example, the tax benefit merely relates to the timing of the recognition of exempt earnings, the result under regulation 5907(2.02) seems to be punitive.

Regulation 5907(2.02) also introduces an additional level of uncertainty and complexity in the foreign affiliate area. Assessing whether a transaction is an "avoidance transaction" requires an examination into the various purposes of the particular transaction, as well as their relative importance, with a view to ascertaining whether the transaction was undertaken "primarily" for non-Canadian tax purposes. This could be very a difficult and time consuming exercise, given that a purpose test is fact specific and each addition to exempt earnings may need to be analyzed. Further, the application of any purpose test inherently gives rise to uncertainty since it is a judgment-based exercise.

This uncertainty and complexity is heightened by the increased emphasis on surplus balances under recent proposals. Historically, surplus balances have been primarily relevant only when a dividend is paid (either under section 113 or paragraph 55(5)(d)); however, under recent amendments, surplus balances are now relevant for other purposes. For example, the surplus balances will be relevant in determining whether taxpayers are entitled to a deduction under subsection 90(6) and this determination must be made on an annual basis. Surplus balances are now also relevant in the context of arm's length acquisitions where the purchaser intends to effect a paragraph 88(1)(d) bump.

Submission

In light of the foregoing, we question the need for such a broad rule and suggest that the GAAR, together with other proposals (such as the hybrid surplus rules and regulation 5907(2.3)), should be sufficient to address concerns relating to the "artificial" creation of exempt surplus. However, if a specific measure is felt to be warranted, we suggest that it be modified so that it is more in line with the stated purpose of the rule. Based on informal discussions, we understand that Finance did not intend for this rule to apply to paragraph 95(2)(a) amounts and currently intends to modify the proposal accordingly. However, given that "exempt earnings" includes items in addition to paragraph 95(2)(a) amounts, we suggest that the rule be further modified so that it is limited to internal transfers of excluded property other than shares, other than transfers occurring in the ordinary course of business.

6. Foreign Accrual Tax and Proposed Regulations 5907(1.4) to (1.6)

As drafted, to qualify as foreign accrual tax, a compensatory payment that is in respect of another corporation's loss must reasonably be considered in respect of a foreign accrual property loss ("FAPL") of another controlled foreign affiliate of the taxpayer or related persons. If the foreign accrual tax is initially denied, regulations 5907(1.5) and (1.6) may reinstate the denied foreign accrual tax for that taxation year provided that the taxpayer can demonstrate the following conditions have been met:

(i) all losses of the particular foreign affiliate and other corporations referred to in regulation 5907(1.3)(a) would have been fully deducted against the active business income of the particular foreign affiliate or any other corporations that form part of the consolidated group under the relevant tax law referred to in regulation 5907(1.3)(a);

(ii) no other losses of the particular foreign affiliate or any other corporations for any taxation year were, or could reasonably have been, deducted under the relevant tax law against that income; and

(iii) the losses are used up within 5 years of the year in which the FAPI is realized.

The reference to regulation 5907(1.3)(a) in regulations 5907(1.5) and (1.6) restricts the reinstatement of denied foreign accrual tax to foreign affiliates that determine their income tax payable on a consolidated or combined basis. This would mean that a tax sharing payment made by a controlled foreign affiliate to another foreign affiliate in respect of a loss of that other foreign affiliate pursuant to regulation 5907(1.3)(b) would not qualify for the reinstatement of denied foreign accrual tax. From a policy viewpoint we do not see why the rules in regulations 5907(1.5) and (1.6) are only available to foreign affiliates that are subject to the tax loss sharing system as described in regulation 5907(1.3)(a) and not 5907(1.3)(b).

Furthermore, the denied foreign accrual tax will only be reinstated if the full amount of the loss has been deducted against the active business income of the particular affiliate or any other corporation that form part of the consolidated group within 5 years of the year in which the FAPI is realized. This means that the reinstatement is an all or nothing approach. If the losses are not fully deducted against active business income within the 5 year window, the reinstatement of the foreign accrual tax will be permanently lost.

Submission

Regulations 5907(1.5) and (1.6) should be expanded to include a reference to regulation 5907(1.3)(b). In addition, instead of an all or nothing approach, we recommend adopting a pro-rata approach and expanding the 5 year window in proposed regulation 5907(1.6)(c).

7. Revocation Deadline for the Foreign Affiliate Elections

The August 2011 proposals provide taxpayers with the ability to elect retroactive application in respect of certain proposals. The provisions, if elected, will apply to several prior years (in some cases to 1994), in respect of all foreign affiliates of the taxpayer. It will be difficult for taxpayers to reasonably determine whether there are any detrimental effects to making these elections and whether they would benefit from any changes that will fix anomalies to the provisions. As such, like with the Bill C-28 foreign affiliate elections, taxpayers should be able to revoke the elections in order to provide comfort that they will be no worse off after having made the elections.

Submission

We recommend that the elections be revocable by the taxpayer until the end of the reassessment period for all of the taxpayer's affected years.

8. Integration and Private Corporations

Private corporations have, historically, not been entitled to include the non-taxable portion of capital gains realized by a foreign affiliate in their capital dividend account when the funds from a sale of a capital property by an affiliate have been paid-up to the private corporation out of exempt surplus. The introduction of the concept of hybrid surplus offers an opportunity to address this longstanding lack of tax integration, at least in part.

Furthermore, the existing tax provisions lack neutrality. When considering investments in foreign affiliates, private corporations are faced with the difficult decision of whether to hold such investments directly and thereby benefit from the capital dividend account provisions, or to hold them indirectly through a foreign holding company and take advantage of the many commercial and foreign tax benefits such structures afford. The introduction of the concept of hybrid surplus also offers an opportunity to address this lack of tax neutrality. This is because hybrid surplus specifically tracks capital gains and losses on foreign affiliate shares that are held indirectly.

Submission

We recommend that Finance include the amount of a dividend received by a private corporation from a foreign affiliate out of its hybrid surplus that is deductible pursuant to proposed paragraph 113(1)(a.1) in the corporation’s capital dividend account.

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