

In Print

Foreign Affiliate Update

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This article provides an update on a number of key foreign affiliate technical amendments to the *Income Tax Act* that the Department of Finance has released. In particular, it covers the proposed amendments to subsection 88(3) with respect to top-tier foreign affiliate distributions, internal transfers and suspension rules proposed in paragraphs 95(2)(c.1) through (c.6), (f.3) through (f.9) and (h) through (h.5), and foreign affiliate mergers, liquidations and distributions proposed in paragraphs 95(2)(d), (d.1), (e), (e.1), (e.3), (e.4) and (e.5).

It covers a number of significant proposals to the foreign affiliate reorganization provisions.

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Foreign Affiliate Update

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Nearly four years have passed since the Department of Finance issued detailed proposals to amend the existing foreign affiliate provisions in the Canadian *Income Tax Act*¹ on December 20, 2002.² This proposed legislation contained the most sweeping changes to the foreign affiliate rules since the foreign affiliate amendments of 1994. The December 20, 2002 draft legislation was fraught with many anomalies and issues, forcing Finance to issue a second set of draft proposals on February 27, 2004.³ Unfortunately for taxpayers, the 2004 Proposals created even more anomalies and issues. It has been over 2½ years since the second set of draft proposals were issued, and we have yet to see a third draft. Finance has issued a number of comfort letters and other announcements to address some of the anomalies and issues raised by taxpayers and members of the tax community.

The purpose of this paper is to provide an update on three key portions of the draft foreign affiliate legislation:

1. Subsection 88(3), dealing with top-tier foreign affiliate distributions;
2. Internal transfers and suspension rules, in particular proposed paragraphs 95(2)(c.1) through (c.6), (f.3) through (f.9), and (h) through (h.5); and
3. Foreign affiliate mergers, liquidations and distributions, namely proposed paragraphs 95(2)(d), (d.1), (e), (e.1), and (e.3) through (e.5).

For each of these three sections of legislation, both the currently enacted legislation and the proposed legislation are discussed. As well, comfort letters and announcements issued by the Department of Finance on these sections of the proposed legislation, up to October 31, 2006, are discussed in detail.

SUBSECTION 88(3) — TOP-TIER FOREIGN AFFILIATE DISTRIBUTIONS

Currently Enacted Subsection 88(3)

Subsection 88(3) is often referred to as a top-tier foreign affiliate liquidation provision. Currently enacted subsection 88(3) applies where, on the dissolution of a controlled foreign affiliate (“FA1”) of a taxpayer (“Canco”), shares

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of another foreign affiliate (“FA2”) of Canco have been disposed of to Canco.⁴

Currently enacted paragraph 88(3)(a) deems FA1 to have disposed of its FA2 shares for proceeds of disposition equal to FA1’s adjusted cost base (“ACB”) in those shares. Canco can elect a greater amount of proceeds of disposition for FA1, up to the fair market value of the FA2 shares immediately before the dissolution. The cost of the FA2 shares to Canco would equal FA1’s proceeds of disposition for those shares.

Under currently enacted provisions, if the FA2 shares are *excluded property*⁵ of FA1 and Canco elects an amount greater than the ACB of the FA2 shares, any gain recognized by FA1 would be allocated one half to exempt surplus and one half to taxable surplus.⁶ None of the gain would be *foreign accrual property income*⁷ (“FAPI”). However, any gain recognized by FA1 would be FAPI if the FA2 shares are not excluded property of FA1.

Under currently enacted paragraph 88(3)(b), Canco’s proceeds of disposition for its FA1 shares would be equal to the following:

1. Canco’s cost in the FA2 shares received from FA1, as determined under paragraph 88(3)(a) (i.e., FA1’s proceeds of disposition for those shares); *plus*
2. The fair market value of any other property distributed to Canco upon FA1’s dissolution; *less*
3. The total of all debts owing by FA1 that were assumed or cancelled by Canco upon the dissolution.

As a result, Canco could recognize a gain or loss upon the dissolution of FA1. Such gain or loss would be a capital gain or loss provided Canco held the FA1 shares as capital property.

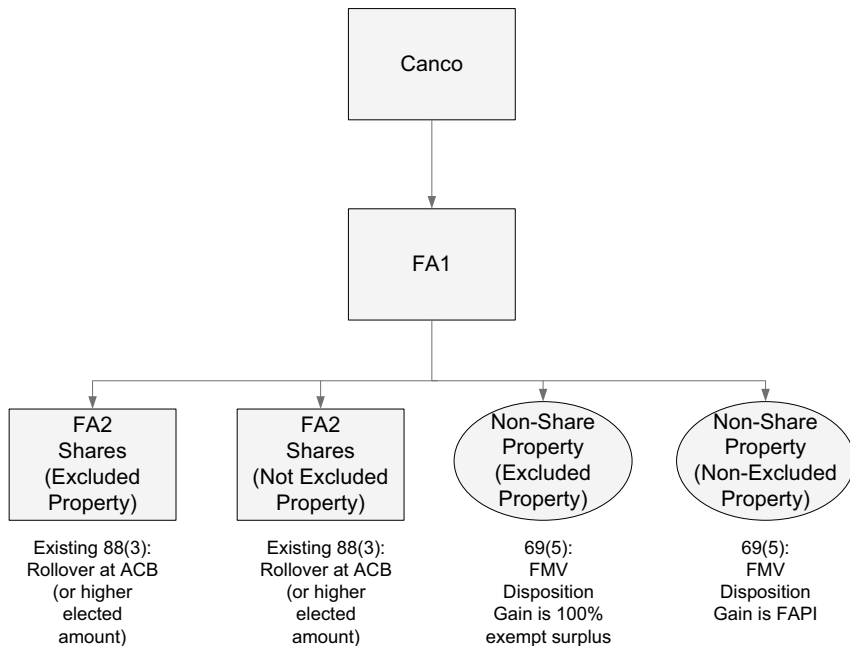
Currently enacted subsection 88(3) only addresses the distribution of FA2 shares by FA1 upon FA1’s dissolution. The distribution of any property other than shares of a foreign affiliate is not addressed by existing subsection 88(3). As well, any distribution of property other than in the course of a dissolution of FA1 is not addressed by existing subsection 88(3).

Under currently enacted legislation, subsection 69(5) should provide the Canadian income tax consequences of FA1’s distribution of any property other than shares of a foreign affiliate (“non-share property”) upon its winding-up. Under paragraph 69(5)(a), FA1 would be deemed to have disposed of its non-share property immediately before the winding-up for proceeds of disposition equal to the fair market value of the property at that time. Where FA1 recognizes a gain on non-share property that is excluded property, the entire gain would be added to FA1’s exempt surplus, provided the excluded property was used by FA1 to earn income from an active business carried on in a designated treaty country.⁸ Where FA1 recognizes a gain on non-share property that is not excluded property, the gain would be FAPI. Under paragraph 69(5)(b), Canco’s cost of the non-share property

received upon FA1's winding-up would be equal to the property's fair market value immediately before the winding-up.

Refer to Figure 1 for a summary of the mechanics of currently enacted subsection 88(3).

Figure 1



Proposed Subsection 88(3) — February 27, 2004

The 2004 Proposals included significant amendments to subsection 88(3). The amendments to subsection 88(3) set out in the 2004 Proposals (hereinafter referred to as “2004 subsection 88(3)”) broadened the application of this provision. 2004 subsection 88(3) applies where a Canadian resident taxpayer (“Canco”) receives property from a foreign affiliate (“FA1”), whether or not FA1 is a controlled foreign affiliate of Canco, as a result of:

1. A dissolution and liquidation of FA1;
2. A redemption of shares of FA1;
3. A payment of a dividend by FA1; or
4. A distribution of property by FA1.

2004 Paragraph 88(3)(a)

2004 paragraph 88(3)(a) applies where FA1 transfers property to Canco that is shares of another foreign affiliate (“FA2”) and those shares are excluded property of FA1. FA1 is deemed to have disposed of the FA2 shares for proceeds of disposition equal to FA1’s ACB in the FA2 shares. Canco can elect to have FA1 have a greater amount of proceeds of disposition. The amount elected by Canco cannot be less than the ACB nor greater than the fair market value of the FA2 shares. Canco is deemed to have acquired the FA2 shares at a cost equal to FA1’s proceeds of disposition for the FA2 shares (as determined under 2004 subparagraph 88(3)(a)(i)).

If Canco makes the election, such that FA1 recognizes a gain on the transfer, the gain is FAPI under the amended definition of FAPI⁹ in the 2004 Proposals. As a result, there is no potential for FA1 to trigger any exempt surplus by making the election, notwithstanding that the FA2 shares are excluded property of FA1. Proposed subsection 93(1.4) would deny the ability to make a subsection 93(1) election to reduce the FAPI, since 2004 paragraph 88(3)(a) applies.

2004 Paragraph 88(3)(b)

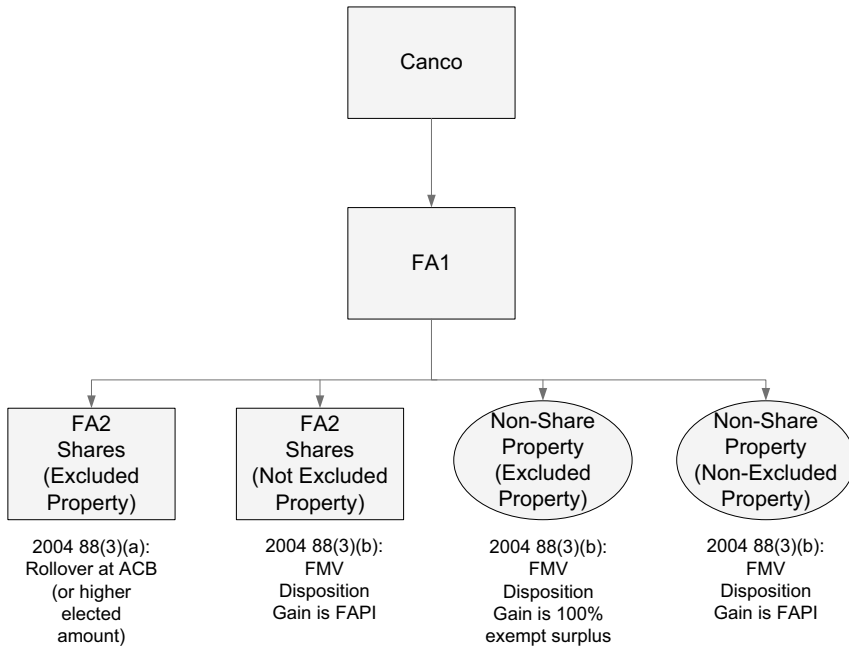
2004 paragraph 88(3)(b) applies where 2004 paragraph 88(3)(a) does not apply. That is, where the property received by Canco (the “distributed property”) is not shares of a foreign affiliate, or if the distributed property is shares of a foreign affiliate, the shares are not excluded property to FA1. In this case, under 2004 subparagraph 88(3)(b)(i), FA1 is deemed to have disposed of the distributed property for proceeds of disposition equal to the fair market value of the distributed property. Pursuant to 2004 subparagraph 88(3)(b)(ii), Canco is deemed to have acquired the distributed property at a cost equal to FA1’s proceeds of disposition, that is, at the fair market value of the distributed property.

If the distributed property is excluded property that is an active business asset, then any income or capital gain recognized by FA1 would generate exempt and/or taxable surplus.¹⁰ Note that the suspended gain rules in proposed paragraphs 95(2)(f.3) and (f.4) should not apply because proposed paragraph 95(2)(f.6) precludes their application where 2004 subsection 88(3) otherwise applies. If the distributed property is not excluded property, any gain would be FAPI.

The significant difference between 2004 subsection 88(3) and currently enacted subsection 88(3) is that the proposed legislation no longer allows a rollover of FA2 shares unless they are excluded property. As a result, the proposed legislation makes the determination of excluded property status for FA2 shares even more critical than under existing legislation.

Refer to Figure 2 for a summary of 2004 paragraphs 88(3)(a) and (b).

Figure 2



2004 Paragraph 88(3)(c)

2004 paragraph 88(3)(c) applies where Canco disposes of the shares of FA1 on the dissolution and liquidation of FA1 or on the redemption, acquisition or cancellation of the shares of FA1. This paragraph determines the proceeds of disposition for the shares of FA1 disposed of by Canco. Canco is deemed to have disposed of the FA1 shares for proceeds of disposition equal to:

1. Canco's cost amount of the property received from FA1 as consideration for the disposition of the FA1 shares; less
2. The amount of debts and obligations of FA1 that Canco either assumes or cancels because of FA1's dissolution and liquidation (or because of the redemption, acquisition or cancellation of the FA1 shares, as the case may be).

2004 Paragraph 88(3)(d)

2004 paragraph 88(3)(d) applies where Canco receives property as a dividend or a distribution of property from FA1. This paragraph is similar to 2004 paragraph 88(3)(c) in that the amount of the dividend or distribution of property is equal to:

1. Canco's cost of the property received from FA1 as a dividend or distribution of property, less
2. The amount of debts and obligations of FA1 that Canco either assumes or cancels because of the dividend or distribution of property.

2004 Paragraph 88(3)(e)

2004 paragraph 88(3)(e) applies where Canco receives a distribution of property from FA1 and it is reasonable to consider the distribution to be either:

1. A return of an amount that was received by FA1 as consideration for the issuance of its shares to Canco, that is, a return of share capital; or
2. A return of contributed surplus that was received by FA1 as a contribution to its capital by Canco.

In either case, Canco would reduce its ACB in the FA1 shares by the amount of the distribution of property.

2004 Paragraph 88(3)(f)

2004 paragraph 88(3)(f) applies where Canco receives a distribution of property from FA1 and does not deduct the amount from the ACB in the FA1 shares under 2004 paragraph 88(3)(e). In this case, Canco must include the amount of the distribution in its income as income from property (where the property is the FA1 shares).

This paragraph appears to link with 2004 paragraph 88(3)(d) with respect to distributions of property that are not dividends. 2004 paragraph 88(3)(d) determines the amount of the distribution and 2004 paragraph 88(3)(f) requires that Canco treat the distribution as income from property.¹¹

2004 paragraph 88(3)(f) appears to address FA1 distributions of property that are neither returns of capital, returns of contributed surplus, nor dividends, and that are not in connection with a redemption of FA1 shares or a dissolution and liquidation of FA1. One possible example of where this paragraph could apply is to an appropriation of FA1 property by Canco that, under the corporate laws of FA1's country of incorporation, is not considered a dividend, a return of capital, a return of contributed surplus, a redemption of FA1 shares, or a liquidation and dissolution of FA1.

Subsection 88(3) Comfort Letters

The amendments to subsection 88(3) under the 2004 Proposals created many unanswered questions and unresolved issues. Since the 2004 Proposals were released, the Department of Finance ("Finance") has issued a number of comfort letters and other announcements that attempt to clarify portions of 2004 subsection 88(3), and in some cases, modify the proposals. Set out below is a chronological discussion of the comfort letters and announcements that attempt to clarify and modify 2004 subsection 88(3).

August 19, 2004 Comfort Letter

In a comfort letter issued on August 19, 2004, Finance confirmed its position that 2004 subsection 88(3) was not intended to change the tax outcome of a return of capital payment made by FAI to Canco. In particular, Finance indicated that the payment would reduce Canco's ACB in its FAI shares under paragraph 53(2)(b) and Canco would not have an income inclusion from the return of capital payment, other than any capital gain triggered under subsection 40(3) by any negative ACB. Finance also stated that it was considering further revisions to 2004 subsection 88(3) but these revisions would not change the tax outcome described above.¹²

January 19, 2005 Comfort Letter

In a comfort letter issued on January 19, 2005, Finance stated that, in response to a submission, it intends to recommend a revision to 2004 subsection 88(3). Where Canco receives a return of capital payment from FAI, and the amount of the payment exceeds the aggregate amount of reductions to Canco's ACB in the FAI shares, that excess portion of the payment would be treated as a payment of a dividend on the FAI shares.

The apparent purpose of this revision is to allow Canco to access subsection 113(1) deductions, in particular a deduction under paragraph 113(1)(d) for dividends paid out of pre-acquisition surplus. If Canco receives a return of capital payment from FAI that exceeds both the paid-up capital and Canco's ACB of the shares,¹³ it appears that, through the application of 2004 paragraphs 88(3)(e) and (f), the excess amount would be income from property to Canco.

Consequently, the proposed revision to 2004 subsection 88(3) is required so that the excess amount would be treated as a dividend out of pre-acquisition surplus. As a result, the excess amount would reduce Canco's ACB to a negative amount,¹⁴ thereby triggering the application of subsection 40(3), and consequently, a capital gain only one half of which would be taxable to Canco (instead of income from property that would be fully taxable).

August 16, 2005 Comfort Letter

In a comfort letter issued on August 16, 2005, Finance stated its support for significant, generally taxpayer-favourable amendments to 2004 subsection 88(3). Finance did not provide detailed draft legislation, however it did provide a general outline of the proposed amendments.

Qualifying Liquidations and Dissolutions

Finance proposed an additional and distinct rule for "qualifying liquidations and dissolutions" ("QLDs") of FAI into Canco. In order to qualify as a QLD, Canco must:

1. Own at least 90% of the voting rights (at a general meeting) of FAI in all circumstances; and

2. Receive at least 90% of the fair market value of all properties distributed by FA1 to all of its shareholders in the course of its liquidation and dissolution.

It is not clear from the comfort letter whether these 90% ownership thresholds include only FA1 shares owned directly by Canco, or whether FA1 shares owned by persons related to Canco could also be included in the 90% determination.

For a QLD (and only for a QLD), Canco can elect to have the following rules apply (query whether Canco can elect for only certain of the rules to apply):

1. FA1 would be deemed to have disposed of each property distributed to Canco for proceeds of disposition equal to the greater of:
 - a. The “relevant cost amount” of the distributed property; and
 - b. The amount elected by the taxpayer, which cannot exceed the fair market value of the distributed property.¹⁵

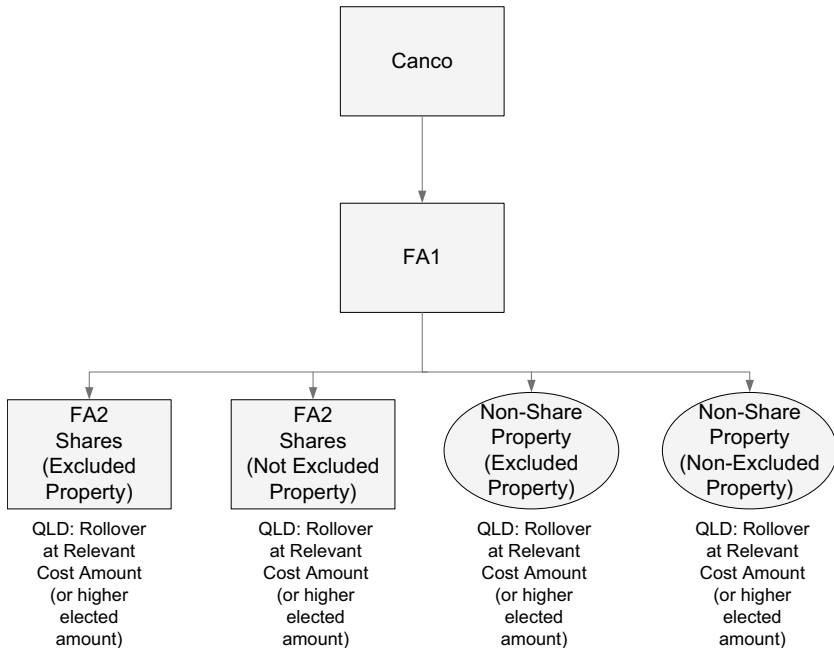
Finance defined “relevant cost amount” to be the amount that would generally result in no gain or loss to FA1 in respect of the disposition of the distributed property.

Consider the situation where Canco acquired FA1 from an unrelated party and at the time of the acquisition FA1 held a property with an accrued gain. In computing its gain or loss from a subsequent disposition of the property, FA1 would not include the portion of the gain or loss that accrued in the pre-acquisition period.¹⁶ In this situation, presumably the “relevant cost amount” of FA1’s capital property would be the ACB of the property, plus any accrued gain or less any accrued loss attributed to the pre-acquisition period. Using this approach, FA1 should not recognize any gain or loss on the distribution of the property to Canco because of paragraph 95(2)(f).

This new provision would significantly broaden the ability to transfer FA1’s property to Canco on a rollover basis. Under 2004 subsection 88(3), only FA2 shares owned by FA1 that are excluded property could be transferred to Canco on a rollover basis. Under the proposed QLD rules, all FA1 property, whether shares, active business assets or passive investment assets, and whether excluded property or not excluded property, could be transferred to Canco on a rollover basis, but only if there is a QLD of FA1.

Refer to Figure 3 for a summary of this proposed provision.

Figure 3



- Any income or taxable capital gains recognized by FA1 from the disposition of the distributed property would be FAPI, whether the distributed property is excluded property or not excluded property. Income or taxable capital gains would be recognized only if the taxpayer elects to recognize income or gains.

This rule would be consistent with the suspension rules in 2004 paragraphs 95(2)(c.2) and (f.4), where income and gains should be recognized only on an elective basis, and such elected income and gains would be FAPI, notwithstanding the fact that the transferred property is excluded property.

- Canco's cost of the distributed property would equal FA1's proceeds of disposition for the property.
- The amount of the distribution made by FA1 to Canco would be deemed to equal Canco's cost of the distributed property, less debts and obligations of FA1 that are assumed or cancelled by Canco, less any amounts paid by Canco to FA1 as consideration for the distributed property.
- The amount of the distribution made by FA1 to Canco would be treated:

- a. Firstly, as a return of FA1's "foreign paid-up capital" ("FPUC"), which Finance defined, on a share by share basis, as the particular share's portion of the total amounts contributed by FA1's shareholders to FA1 in respect of the FA1 shares issued to or held by those shareholders; and
- b. Secondly, as a dividend paid by FA1 to Canco to the extent the distribution is not treated as a return of FPUC.

It should be noted that this ordering is not elective.

These revisions to subsection 88(3) would apply to liquidations and dissolutions of FA1 that begin after February 27, 2004.

January 20, 2006 Joint Committee Submission

On January 20, 2006, the foreign affiliate subcommittee of the Joint Committee on Taxation¹⁷ (the "Joint Committee") set out its comments on FPUC. Among the Joint Committee's recommendations to Finance were the following:

1. The characterization of a foreign affiliate distribution should not be determined as a function of the foreign affiliate's FPUC. The Joint Committee explained that where Canco acquires FA1 shares from an unrelated party for an amount in excess of the FPUC of those shares, such that ACB exceeds FPUC, then double taxation could occur under the comfort letter proposals with respect to distributions made by FA1 to Canco. Canco could receive a distribution of "tax-paid" ACB that would be taxable to Canco where it exceeds FPUC.
2. Where a foreign affiliate makes a dividend payment or other distribution of property, the distribution should, by default, be treated as a dividend. Taxpayers should then be able to elect to treat the distribution as a reduction of ACB instead.
3. If the concept of FPUC is to be introduced into the foreign affiliate rules, it should be maintained in the relevant shareholder's calculating currency, that is, Canadian dollars for Canco.

Subsequent Finance comfort letters and announcements have thus far adopted only the second and third recommendations above.

April 12, 2006 Comfort Letter

In a comfort letter issued on April 12, 2006, Finance made supplementary comments with respect to its proposed QLD rules. Finance clarified the following:

1. Canco could elect for FA1 to recognize gain from the distribution of property in the QLD, but only if FA1 is a controlled foreign affiliate of Canco.

2. Any loss of Canco from the redemption, acquisition or cancellation by FA1 of its shares in the course of the QLD would be deemed to be nil. This would apparently override paragraph 69(5)(d), which would have “turned off” the loss suspension rules in subsections 40(3.4) and (3.6).
3. In computing the FPUC of a particular class of FA1 shares, where non-cash property was contributed to FA1 in respect of shares of that class, the amount added to FPUC in respect of that contribution would be determined by reference to the cost to FA1 of that contributed property. An exception would apply where the contributed property is shares of another foreign affiliate of Canco, in which case the amount added to FPUC would be limited to the FPUC in respect of the shares of the other foreign affiliate.
4. The amounts required to be determined under subsection 88(3) and related provisions would be determined in Canadian dollars.

The changes proposed in this April 12, 2006 comfort letter would be effective for liquidations and dissolutions of foreign affiliates beginning after February 27, 2004.

May 8, 2006 IFA International Tax Seminar

During the International Fiscal Association (“IFA”) International Tax Seminar on May 8, 2006, Finance officials made the following announcements:

1. Revised rules would apply to non-QLD transactions. Now, any non-excluded property with an accrued gain would be disposed of for fair market value proceeds, thereby triggering FAPI, while any non-excluded property with an accrued loss would be disposed of for the relevant cost amount of that property, thereby preventing the recognition of a foreign accrual property loss (a “FAPL”) and preserving the accrued loss in Canco’s hands. It is not clear from a Finance policy perspective why this inequitable result for taxpayers should arise.
2. Any subsection 40(3) gain created by a return of FPUC that drives ACB negative could be reduced by making a subsection 93(1) election.
3. For any non-redemption, non-liquidation distribution, such as a dividend, Canco may elect that any portion be a deemed return of FPUC, regardless of the legal form of the distribution. This appears to follow the Joint Committee’s recommendation discussed above.
4. A new subsection 88(3) shareholder benefit rule will apply to a distribution that is not in respect of shares. The benefit would be ordinary income, rather than a dividend, to the shareholder, and the subsection 88(3) rule will specify that subsection 15(1) does not apply. It is possible that this new shareholder benefit rule may be drafted as an extension of 2004 paragraph 88(3)(f).

June 9, 2006 Comfort Letter

Finance issued a comfort letter on June 9, 2006 that addressed the determination of FPUC. In the situation described in the comfort letter, Canco contributed cash, for no consideration, to its wholly-owned foreign affiliate (“CFA”) as a contribution of capital in respect of the ordinary common shares of CFA (owned by Canco). Under the relevant foreign corporate law, the capital contribution resulted in contributed surplus of the CFA.

CFA wanted to return the entire contributed surplus to Canco. In order to do so under foreign corporate law, CFA must make a bonus issuance of ordinary common shares in order to (1) increase the legal share capital (i.e., the par value) of all ordinary common shares by the amount of contributed surplus, and (2) make a corresponding reduction in the contributed surplus. CFA must then pass a resolution to make a *pro rata* reduction of the par value of all its ordinary shares (including the bonus shares), the total of such reduction equaling the contributed surplus amount.

It appears that this particular foreign corporate law does not allow contributed surplus to be returned to a shareholder. Instead, the contributed surplus must be “converted” into legal share capital, or par value, and then the par value can be reduced.

2004 paragraph 88(3)(e) would reduce Canco’s ACB in its CFA shares by the amount of the distribution, but only if CFA’s distribution was either (i) a return of an amount that CFA received as consideration for the issuance of its shares, or (ii) a return of an amount of contributed surplus that CFA received as a contribution of capital.

In the facts set out in the comfort letter, 2004 subparagraph 88(3)(e)(ii) would not apply because the return of par value would not be a return of contributed surplus. The issue raised was whether the return of par value would meet 2004 subparagraph 88(3)(e)(i), even though the par value being returned was originally received by CFA as a contribution to capital rather than on the issuance of CFA shares.

Finance responded by stating the following:

1. A foreign affiliate, i.e., CFA, can treat a distribution of property to its shareholders as a reduction of FPUC, rather than as payment of a dividend, but only to the extent that there is sufficient FPUC. This apparent election is consistent with comments made by Finance officials at the May 8, 2006 IFA International Tax Seminar.
2. CFA’s FPUC would include all amounts received by CFA on either the issuance of ordinary common shares, or as a contribution of capital.¹⁸ Therefore, it appears that whether CFA’s return of par value fits into 2004 subparagraph 88(3)(e) is no longer relevant, since all legal share capital and contributed surplus would be pooled together in a single FPUC account.
3. Rules will be provided to determine FPUC on a class-by-class basis.

4. Finance will introduce an election that a taxpayer can make that would apply to each of its foreign affiliates. If a taxpayer makes this election, a “transitional” version of new subsection 88(3) would apply. This transitional version would include a provision to determine FPUC on a class-by-class basis, as well as on an individual share basis. Presumably, this transitional subsection 88(3) is intended to address taxpayers who have implemented transactions using 2004 subsection 88(3), but who may not have taken into account revisions to subsection 88(3) set out in subsequent comfort letters.

Conclusions on Subsection 88(3)

The proposals relating to the revision of subsection 88(3) have evolved substantially since the release of the 2004 Proposals. Since the 2004 Proposals, Finance has issued six comfort letters in an attempt to clarify and/or revise portions of the provision. We will have to wait for the next release of draft legislation by the Department of Finance to see whether any or all of the proposed revisions to subsection 88(3), since the 2004 Proposals, will be incorporated in a new set of proposals.

Clearly, the introduction of the concept of FPUC has created many unanswered questions and unresolved issues regarding the role of FPUC in the foreign affiliate rules, and the mechanics of its calculation. Finance appears to have loosened the FPUC rules somewhat, allowing taxpayers to effectively elect what portion of non-redemption, non-liquidation distributions (such as dividends) will be treated as FPUC reductions, and what portion will be treated as dividends.

It is not clear that there is any valid tax policy reason for Finance to continue with the FPUC concept. It is possible that Finance may abandon the FPUC rules and adopt the Joint Committee’s recommendation to continue to use ACB to characterize foreign affiliate distributions. Again, we will have to wait for the next release of draft legislation to see the direction that Finance will take on this matter.

The introduction of a separate set of rules for QLDs is welcome, especially since the new rules treat subsection 88(3) cross-border liquidations in a manner similar to domestic subsection 88(1) liquidations. However, unresolved issues remain for non-QLD transactions, including the asymmetrical treatment of non-excluded property with accrued gains and non-excluded property with accrued losses.

INTERNAL TRANSFERS AND SUSPENSION RULES

A significant subset of the proposed foreign affiliate provisions in both the 2002 Proposals and 2004 Proposals addresses the transfer of property within a foreign affiliate group.

Current Rules

The current provisions in the Act relating to the transfer of property within a foreign affiliate group may allow for the accelerated recognition of exempt surplus in certain circumstances. For example, exempt surplus may arise where a foreign affiliate (“FA1”) transfers the shares of another foreign affiliate (“FA2”) to a third foreign affiliate (“FA3”), if the FA2 shares are excluded property of FA1 and paragraph 95(2)(c) does not apply. Under existing provisions, if FA1 recognized a gain on the transfer, one half of the gain may result in exempt surplus and the other half may result in taxable surplus.¹⁹ In addition, no portion of the gain would be FAPI.²⁰ Where FA1 transfers non-share excluded property to FA3, 100% of any income or capital gain, less any applicable foreign tax, would be added to FA1’s exempt surplus, subject to Regulation 5907(5.1), discussed below.

Existing Regulation 5907(5.1) may apply where FA1 transfers property to a non-arm’s length foreign affiliate (“FA3”) and the property is used or held principally for the purpose of gaining or producing income from an active business. If no gain or loss is recognized on the disposition under applicable foreign tax law, then FA1’s proceeds of disposition would equal the ACB of the property immediately before the disposition. FA3’s ACB of the property would equal FA1’s proceeds of disposition, and FA3 would be deemed to have acquired the property on the date that it was originally acquired by FA1.²¹

Finance is concerned with inappropriate accelerated recognition of exempt surplus, and has three key reasons for this concern:²²

1. Exempt surplus is first in the ordering of surplus pools such that exempt surplus can be paid out before any taxable surplus that has little if any underlying foreign tax;²³
2. Exempt surplus can be used to shelter a Canadian corporation’s gain from the disposition of foreign affiliate shares;²⁴ and
3. Exempt surplus can effectively shelter gains recognized by a Canadian corporation from the disposition of shares of another Canadian corporation, since exempt surplus of a foreign affiliate is included in the safe income of the disposed Canadian corporation.²⁵

Proposed Subsection 93(1.4) — December 20, 2002

The 2002 Proposals introduced a new subsection 93(1.4), which would have resulted in FAPI to the extent that, in the above example, FA1 recognized a capital gain from the disposition of FA2 shares. This is notwithstanding that the FA2 shares were excluded property of FA1. Taxpayers strongly objected to proposed subsection 93(1.4) in the 2002 Proposals.

The scope of Regulation 5907(5.1) was expanded in the December 20, 2002 proposals to include income arising from the disposition of non-capital property. No surplus adjustments would be permitted if the

disposition was subject to non-recognition treatment in the foreign jurisdiction.

In a comfort letter issued on October 20, 2003, Finance announced that proposed subsection 93(1.4) would be amended to provide that FAPI would arise on FA1's disposition of FA2 shares that were excluded property, only if the taxpayer elected to recognize gain.²⁶

February 27, 2004 Proposals

The 2004 Proposals also attempt to address Finance's concern regarding accelerated surplus recognition on internal transfers. The proposals repealed Regulation 5907(5.1), due to the introduction of the new internal disposition rules discussed below. Consistent with Finance's comments in the October 20, 2003 comfort letter, the 2004 Proposals limit FAPI recognition to situations in which the taxpayer elects to recognize gain. However, the 2004 Proposals introduced a new regime that would restrict the creation of surplus by suspending the recognition of gains on internal dispositions until there is an appropriate triggering event that releases the gain and the surplus.

The 2004 Proposals regarding internal transfers within foreign affiliate groups can be grouped into the following three categories:

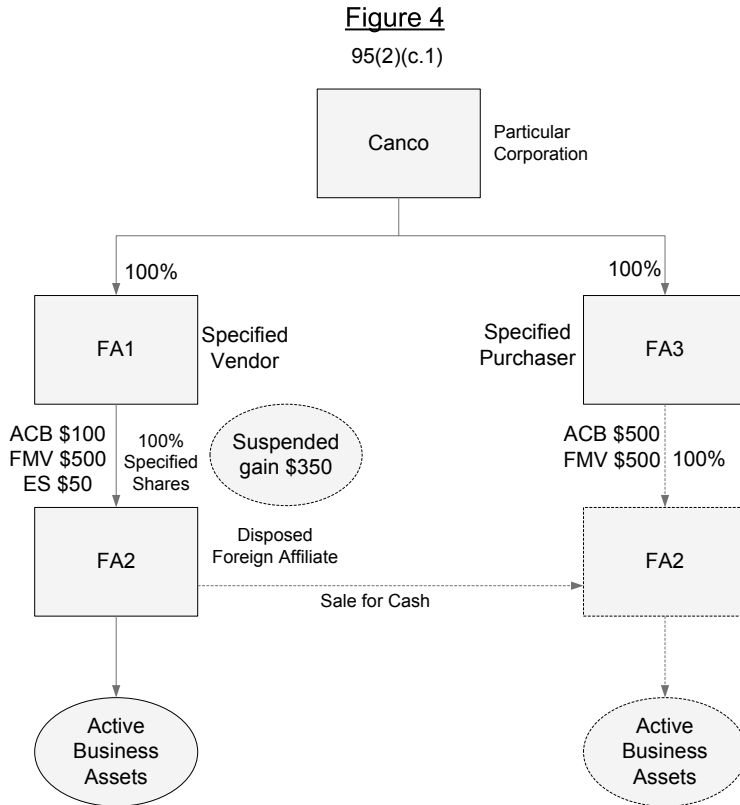
1. Proposed paragraphs 95(2)(c.1) through (c.6) — Internal transfers of foreign affiliate shares that are capital property and excluded property;
2. Proposed paragraphs 95(2)(f.3) through (f.9) — Internal transfers of excluded property other than shares that are capital property; and
3. Proposed paragraphs 95(2)(h) through (h.5) — Internal transfers of non-excluded property at a loss.

Proposed Paragraphs 95(2)(c.1) through (c.6)

Proposed paragraph 95(2)(c.1) sets out the circumstances under which proposed paragraph 95(2)(c.2) would apply. Generally, proposed paragraph 95(2)(c.2) would apply where a "specified vendor" ("FA1") disposes of a foreign affiliate share (a "specified share", e.g. an "FA2" share) to a "specified purchaser" ("FA3"), and:

1. Immediately before the "original disposition time" the FA2 share (i.e. the "specified share") is excluded property of FA1 (i.e. the "specified vendor");²⁷
2. FA1 (i.e. the "specified vendor") has a taxable capital gain from the disposition;²⁸ and
3. The disposition is not governed by another internal disposition provision.²⁹

Proposed paragraphs 95(2)(c.1) through (c.6) would generally apply to dispositions that occur after December 20, 2002. Refer to Figure 4 for a diagrammatic description of proposed paragraph 95(2)(c.1).



The definitions applicable to proposed paragraphs 95(2)(c.1) through (c.6) are contained in proposed subsections 95(3.2) and (3.3). One criticism that has been levied against these proposed rules is that the new defined terms in proposed subsections 95(3.2) and (3.3) are worded too broadly. For example, the definition of “specified purchaser”, as it relates to partnerships and trusts, has a very low ownership threshold. The following example illustrates the issue.

Assume that FA1 transfers its FA2 shares to a partnership (“LP”) that meets the definition of a “specified purchaser”. That is, a partnership in which any of the following has an interest, directly or indirectly in any manner whatever:

1. The Canadian corporation of which FA1 is a foreign affiliate (“Canco”);

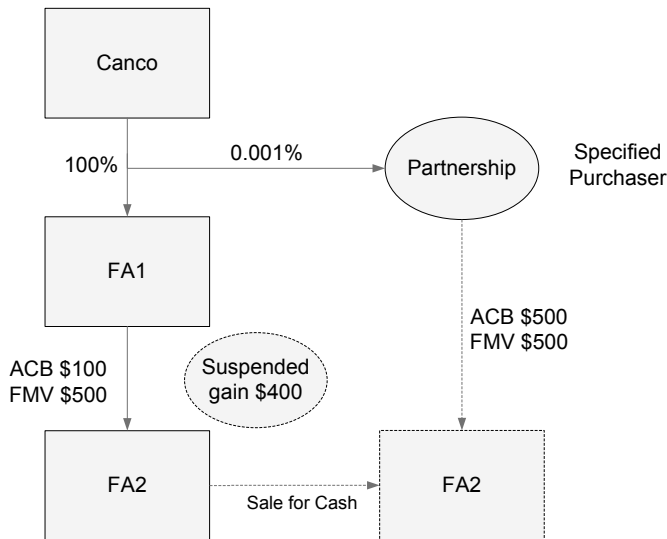
2. A taxpayer resident in Canada with which Canco does not deal at arm's length;
3. A foreign affiliate of a person described in (1) or (2) above;
4. A non-resident person with which a person described in any of (1), (2) or (3) above does not deal at arm's length; or
5. A trust (other than an exempt trust) in which a person described in any of (1), (2), (3) or (4) above is beneficially interested.³⁰

FA1's gain, and therefore surplus, would remain suspended until all LP interests owned by each of the persons described above are disposed of outside the group. Therefore, FA1's gain would remain suspended even if the group's direct or indirect ownership in LP is reduced to a mere portfolio investment. Refer to Figure 5 for a summary of this example.

It is unclear whether Finance's concern regarding inappropriate surplus acceleration is warranted where FA1 transfers FA2 to a partnership that is only 0.001% owned by Canco. This concern may be alleviated if a *de minimus* rule is introduced.

Figure 5

Disposition to a specified purchaser



If the circumstances set out in proposed paragraph 95(2)(c.1) are met, such that proposed paragraph 95(2)(c.2) would apply, proposed subparagraph 95(2)(c.2)(i) would deem FA1 to have disposed of the FA2 shares for proceeds of disposition equal to FA1's ACB of the shares, plus any amount

that FA1 is deemed to receive under subsection 93(1) because of subsection 93(1.1). Where FA1 is a controlled foreign affiliate of a corporation resident in Canada (“Canco”), FA1 may elect to have a greater amount of deemed proceeds of disposition, up to the fair market value of the consideration FA1 receives from the disposition. The taxable portion of the resulting capital gain recognized by FA1 would be FAPI.

Proposed subparagraph 95(2)(c.2)(iii) would deem FA3’s cost of the FA2 shares to be equal to their fair market value at the original disposition time. Proposed subparagraph 95(2)(c.2)(iv) would deem FA1’s cost of the consideration it receives for the FA2 shares to be the fair market value of the consideration at the original disposition time.

Proposed subparagraph 95(2)(c.2)(v) would deem the unrecognized portion of FA1’s gain from the FA2 shares to be an “unadjusted suspended gain” of FA1 in respect of the FA2 shares. Proposed paragraph 95(2)(c.3) would essentially “unsuspend” this suspended gain at the earlier of the following:

1. The first time, after the original disposition time, that a specified purchaser of the FA2 shares makes a “triggering disposition” of the FA2 shares; and
2. The first time, after the original disposition time, that a specified purchaser ceases to be a specified purchaser, otherwise than because of a specified discontinuance of the current holder of the FA2 shares.

Proposed Regulation 5912 determines the amount to be included as the “adjusted suspended gain” in respect of the specified shares (the FA2 shares).

A “triggering disposition”, as defined in proposed subsection 95(3.3), is essentially the first disposition of the FA2 shares, after the original disposition time, to a person who is not a specified purchaser.

There is a concern that the definition of “triggering disposition” may not apply as intended in some circumstances. For example, assume that FA1 disposes of shares of FA2 to FA3. Further assume that as part of the same series of transactions, FA3 disposes of the shares of FA2 to an arm’s length person who is not a specified purchaser. A “triggering disposition” will not occur where the disposition of a “specified share” is part of series of transactions that includes the disposition of the “specified share” to a “specified purchaser”.³¹ In this example, even though at the end of the series of transactions the shares of FA2 are owned by an arm’s length person, the series of transactions included the disposition of the shares of FA2 (i.e. the “specified shares”) to FA3 (i.e. the “specified purchaser”). Therefore, the sale of the FA2 shares to an arm’s length person in this case will not be a “triggering disposition” and the suspended gain will not be released.

Finance issued a comfort letter on May 11, 2005 to address this problem. Finance agreed that, from a tax policy perspective, the disposition of the shares of FA2 by FA3 to the arm’s length person should qualify as a

triggering disposition, and should result in a release of FA1's suspended gain from the FA2 shares.

A suspended gain generally will be released when the specified purchaser ceases to be a specified purchaser.³² However, a suspended gain would not be released where the specified purchaser ceases to be a specified purchaser because of a "specified discontinuance", as defined in proposed subsection 95(3.3). A "specified discontinuance" includes a series of transactions where the shares of FA2 become property of a person or partnership that is another specified purchaser.

The definition of a "specified discontinuance" creates a problem similar to the one described above with respect to the definition of a "triggering disposition". A "specified discontinuance" will include a situation where as part of a series of transactions the "specified share" becomes property of a "specified purchaser".³³ Therefore, even where the specified purchaser ceases to be a specified purchaser at the end of the series of transactions, if the shares of FA2 (i.e. the "specified shares") became property of a specified purchaser as part of the series of transactions, then this situation would give rise to a specified discontinuance and the suspended gain would not be released.

Finance addressed this concern in a comfort letter issued on July 17, 2006. The comfort letter indicated that the definition of a "specified discontinuance" in proposed subsection 95(3.3) will be amended so that a "specified discontinuance" will not include a situation where a specified purchaser does not have an interest in the specified shares at the end of a series of transactions.

Concerns have been raised regarding the potential loss of suspended gains in corporate reorganizations. For example, where FA1 is sold outside the group or where FA1 is wound up into Canco. Apparently, Finance is not sympathetic to these concerns and is not planning on remedying these situations.

Rules in proposed paragraphs 95(2)(c.4) through (c.6) provide exceptions to triggering events. Under certain circumstances, these paragraphs deem the specified shares (the shares of FA2) to continue to exist, and to continue to be held by the specified purchaser.

Proposed Paragraphs 95(2)(f.3) through (f.9)

The rules in proposed paragraphs 95(2)(f.3) through (f.9) are similar to the rules in proposed paragraphs 95(2)(c.1) through (c.6) with a few key differences. Proposed paragraphs 95(2)(f.3) through (f.9) are designed to suspend income and capital gains that would otherwise be recognized upon internal transfers of excluded property, other than foreign affiliate shares that are capital property. These new rules replace the rules found in existing Regulation 5907(5.1),³⁴ as well as proposed Regulations 5907(5.1) through (5.3) in the 2002 Proposals. Proposed paragraphs 95(2)(f.3) through (f.9) would apply to dispositions occurring after February 27, 2004.

Proposed paragraph 95(2)(f.3) sets out the circumstances under which proposed paragraph 95(2)(f.4) would apply. Generally, proposed paragraph 95(2)(f.4) would apply where a “specified vendor” (“FA1”) disposes of a “specified property” to a “specified purchaser” (“FA3”), and

1. immediately before the “original disposition time”, the “specified property” is excluded property (but does not include shares of a foreign affiliate that are capital property) of FA1 (“specified vendor”),
2. the disposition of which would give rise to income or a taxable capital gain.

Proposed paragraph 95(2)(f.6) provides that proposed paragraph 95(2)(f.2) would not apply if:

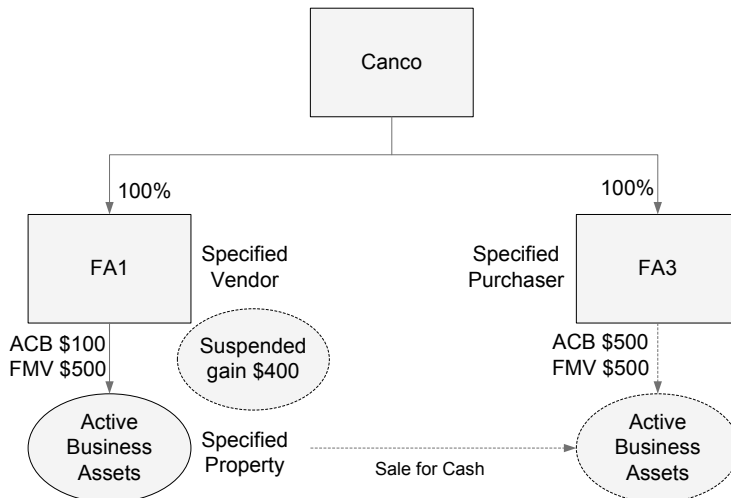
1. any of paragraphs 95(2)(c), (c.2), (d), (d.1), (e), (e.1) and (e.3) to (e.5) would apply to the disposition of the property;
2. subsection 85.1(5) or 88(3) would apply to the disposition of the property;
3. the property was disposed of in the ordinary course of an active business; or
4. the property was disposed of as an adventure or concern in the nature of trade.

The definitions applicable to proposed paragraphs 95(2)(f.3) through (f.9) are contained in proposed subsection 95(3.4). Additional definitions applicable to proposed paragraphs 95(2)(f.3) to (f.7) are contained in proposed subsection 95(3.2), and are the same definitions as for the proposed paragraph 95(2)(c.1) through (c.6) rules.

If the conditions set out in proposed paragraph 95(2)(f.3) are met, and none of the exclusions in proposed paragraph 95(2)(f.6) apply, then proposed paragraph 95(2)(f.4) is applicable. In this case, proposed subparagraph 95(2)(f.4)(i) would deem FA1 to have disposed of the excluded property for proceeds of disposition equal to FA1’s ACB of the property at the original disposition time. Where FA1 is a controlled foreign affiliate of Canco, FA1 may elect to have a greater amount of deemed proceeds of disposition, up to the fair market value of the consideration FA1 receives from the disposition. The resulting income or taxable portion of the resulting capital gain recognized by FA1 would be FAPI. Refer to Figure 6 for a diagrammatic description of proposed paragraph 95(2)(f.3).

Figure 6

95(2)(f.3)



Proposed subparagraph 95(2)(f.4)(ii) would deem FA3's cost of the property to be equal to its fair market value at the original disposition time. Proposed subparagraph 95(2)(f.4)(iii) would deem FA1's cost of the consideration it receives for the property to be the fair market value of the consideration at the original disposition time.

Proposed subparagraph 95(2)(f.4)(iv) would deem the unrecognized portion of FA1's gain from the disposition of the property to be "unadjusted suspended income or gain" of FA1 in respect of the property. Proposed paragraph 95(2)(f.5) would essentially "unsuspend" this suspended income or gain at the earlier of the following triggering events:

1. The first time, after the original disposition time, that a specified purchaser of the property makes a "triggering disposition" of the property; and
2. The first time, after the original disposition time, that a specified purchaser ceases to be a specified purchaser, otherwise than because of a specified discontinuance of the current holder of the property.

New Regulation 5913 determines the amount to be included as the "adjusted suspended income or gain" in respect of the specified property.

Concerns have been raised over the use of FA1's ACB of the property as the deemed proceeds of disposition. The concern arises from the fact that, in the case of depreciable property or other non-capital property such as resource property or eligible capital property, FAPI could be recognized on the disposition on a non-elective basis. For example, assume that the ACB of a property exceeds another relevant cost amount in respect of the property, such as the undepreciated capital cost or the foreign equivalent thereof. In

these circumstances, the deemed proceeds of disposition (assuming the election to recognize FAPI is not made) would exceed that cost amount in respect of the property. The resulting recapture (in the case of depreciable property) would be FAPI, notwithstanding that the recapture would be in respect of excluded property.

In a comfort letter issued on June 6, 2006, Finance noted that this issue had been previously identified, and that it intends to recommend modifications to the draft legislation that would eliminate this issue.³⁵ However, Finance did not give substantial details of the modifications, limiting its comments to the following:

The revisions to proposed subparagraphs 95(2)(e.3)(i) and (f.4)(i) would (except where the taxpayer elects otherwise) permit the foreign affiliate to treat its proceeds of disposition in respect of a disposition of an excluded property to be equal to an amount that would result in no immediate income, gain, loss, surplus or deficit in respect of the disposition. The income, gain, loss, surplus or deficit amount that has not been recognized at the time of the disposition would be recognized when the appropriate circumstances occur.

Presumably, the “appropriate circumstances” would be those identified in proposed paragraph 95(2)(f.5). Finance anticipates that these revisions would have the same application date as proposed paragraphs 95(2)(f.3) through (f.9), that is, to transactions occurring after February 27, 2004.

The comfort letters issued in respect of revisions to the definitions of “triggering disposition” and “specified discontinuance”, discussed above in the context of proposed paragraphs 95(2)(c.1) through (c.6), would equally apply to proposed subsection 95(3.4) which provides similar definitions for proposed paragraphs 95(2)(f.3) through (f.9).

Rules in proposed paragraphs 95(2)(f.7) through (f.9) provide exceptions to triggering events. Under certain circumstances, these paragraphs deem the specified property to continue to exist, and to continue to be held by the specified purchaser.

Proposed Paragraphs 95(2)(h) through (h.5)

In a manner similar to the suspension of income and gains discussed above, proposed paragraphs 95(2)(h) through (h.5) would suspend losses (and allowable capital losses) that would otherwise be recognized on internal transfers of property, other than excluded property, depreciable property or eligible capital property. The suspended loss would otherwise be a FAPL to the vendor. The suspended loss would be released upon a triggering disposition of the property outside the related group. The triggering events for proposed paragraph 95(2)(h.2) are similar to the events in proposed paragraphs 95(2)(c.3) and (f.5) discussed above. A triggering event would occur at the earlier of:

1. A triggering disposition of the property; and

2. The purchaser ceasing to be a specified purchaser, other than because of a specified discontinuance.

New Regulation 5914 determines the amount to be included as the “adjusted suspended loss or capital loss” in respect of the specified property.

These rules would apply to dispositions occurring after February 27, 2004.

The need for proposed paragraphs 95(2)(h) through (h.5) has been questioned because of their similarity to the stop loss rules in subsection 40(3.4). Finance is considering making the currently enacted stop loss rules inapplicable to dispositions of property by foreign affiliates, provided that the property being disposed of is not taxable Canadian property.³⁶

Proposed Suspended Surplus Approach

Two of the more significant problems with the suspended income and gains approach are: (1) the requirement for the taxpayer to track, for each foreign affiliate, both surplus balances and suspended income and gain balances, as well as underlying tax accounts for both sets of balances, and (2) the complexities that this approach creates in moving assets within a corporate group. An alternative “suspended surplus” approach was suggested to Finance by the Joint Committee in a submission dated November 3, 2004. The suggestions were subsequently discussed by Finance with the Joint Committee and a new approach outlined. Brief details of this new approach were presented by members of the Joint Committee at the IFA International Tax Seminar on May 8, 2006 and are discussed below.

Finance and the Joint Committee discussed replacing the suspended income and gains approach with a suspended surplus approach. The suspended surplus approach would treat what would otherwise be the suspended portion of any income or gain realized by a foreign affiliate on an internal disposition in the same way as taxable surplus, until a triggering event occurs. The suspended surplus (and related underlying foreign taxes) would move between foreign affiliates as do other surplus balances, and would remain suspended within the group until a triggering event occurs.

It is expected that Finance will incorporate this suspended surplus approach in the next version of the foreign affiliate proposals and the new proposals will introduce four new accounts:

1. Aggregate suspended income;
2. Aggregate suspended capital gains;
3. Aggregate suspended foreign income tax; and
4. Aggregate suspended foreign capital gains tax.³⁷

These new suspended surplus accounts would operate in the same manner as taxable surplus and underlying foreign tax with respect to dividends paid between foreign affiliates. We understand that it is intended that

the new suspended surplus accounts will rank after taxable surplus and before pre-acquisition surplus in the surplus ordering rules.

Other comments made regarding suspended surplus are as follows:

1. If a foreign affiliate pays a dividend out of its suspended surplus to Canco before a triggering event occurs, the dividend would reduce Canco's ACB in the foreign affiliate's shares in the same manner as the payment of a pre-acquisition surplus dividend.
2. Triggering events occurring before the foreign affiliate pays a dividend out of its suspended surplus to Canco would result in a reclassification of the suspended surplus into corresponding exempt surplus, taxable surplus and/or underlying foreign tax, as the case may be.

Conclusions on Internal Transfers and Suspension Rules

The proposed internal transfer and suspension provisions set out in the 2004 Proposals are not yet well settled. Given the fact that the suspended gain proposals are likely to be replaced with a suspended surplus regime, substantial revisions are anticipated in the next version of the foreign affiliate proposals.

It is hoped that a suspended surplus approach would incorporate the following benefits:

1. The suspended surplus rules could be grafted onto the existing infrastructure in the Regulations;
2. The suspended surplus rules would reduce administrative and compliance costs for taxpayers;
3. Suspended surplus would be treated as taxable surplus so that the Canadian tax base should be fully protected. There would be no need to require the recognition of FAPI as a condition of surplus recognition; and
4. The suspended surplus rules would not interfere with the ability of Canadian multinationals to arrange and restructure their foreign affiliate groups to maximize their international competitiveness.

FOREIGN AFFILIATE MERGERS, LIQUIDATIONS AND DISTRIBUTIONS

Foreign Affiliate Mergers

Paragraphs 95(2)(d) and (d.1) apply to certain mergers of foreign corporations that qualify as "foreign mergers",³⁸ where the shares of one or more of the merging companies (referred to as a "predecessor foreign corporation")³⁹ are owned by a foreign affiliate, and the shares of the predecessor foreign corporation are exchanged for or become shares of the "new foreign

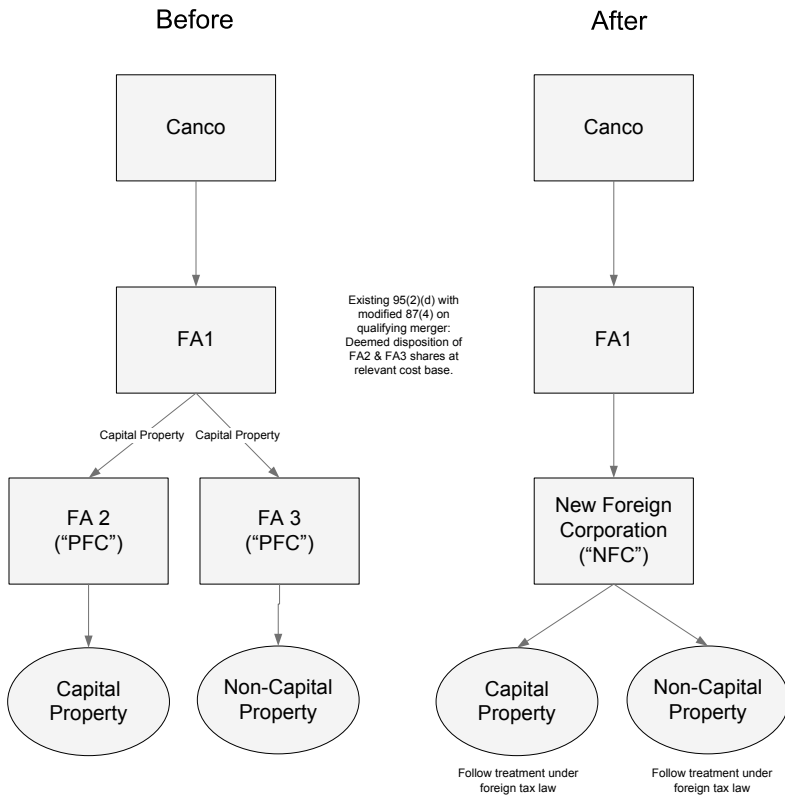
corporation”.⁴⁰ The requirements of a “foreign merger” are drafted in a similar fashion to that of amalgamations in subsection 87(1).

Currently Enacted Paragraph 95(2)(d)

Currently enacted paragraph 95(2)(d) addresses lower-tier foreign affiliate mergers. That is, a foreign merger in which a foreign affiliate (“FA1”) owns shares of a predecessor foreign corporation (“PFC”) immediately before the merger, and those PFC shares were exchanged for or became shares of the new foreign corporation (“NFC”) or the foreign parent corporation. Refer to Figure 7 for a diagrammatic perspective of existing paragraph 95(2)(d).

Figure 7

Existing 95(2)(d)



Paragraph 95(2)(d) would modify subsection 87(4) such that FA1 would be deemed to have disposed of its PFC shares (that are held by FA1 as capital property) for proceeds of disposition equal to their “relevant cost base”.⁴¹ As well, the modified subsection 87(4) would deem FA1’s cost of the NFC

shares that it receives as a result of the foreign merger to equal FA1's proceeds of disposition for the PFC shares.⁴²

Existing paragraph 95(2)(d) does not contain rules that address the disposition of the PFC's property as a result of the foreign merger. This disposition appears to be resolved on a case-by-case basis in accordance with the applicable treatment under foreign law.⁴³

It should be noted that under paragraph 95(2)(d), the PFC itself does not need to be a foreign affiliate of the Canadian taxpayer ("Canco"). However, the shareholder of the PFC (FA1) must be a foreign affiliate of Canco.

Generally, in order for a merger to qualify as a "foreign merger", the following conditions must be met:

1. There must be a merger or combination of two or more PFCs;
2. Each PFC must be a corporation resident in a country other than Canada;
3. The NFC must be a corporation resident in a country other than Canada;
4. All or substantially all of the property of each PFC⁴⁴ must become property of the NFC;
5. All or substantially all of the liabilities of each PFC⁴⁵ must become liabilities of the NFC; and
6. All or substantially all of the shares of each PFC must be exchanged for or become shares of the NFC.⁴⁶

Paragraph 95(2)(d) incorporates the provisions of subsection 87(4). This includes the requirement that no non-share consideration can be received as a result of the merger, in order for the merger to qualify as a rollover transaction, and the requirement that the PFC shares be capital property to FA1 immediately before the merger.

Proposed Paragraph 95(2)(d) — February 27, 2004

Paragraph 95(2)(d), as proposed in the February 27, 2004 draft legislation, still addresses lower-tier foreign affiliate mergers, but now with the following substantial amendments:

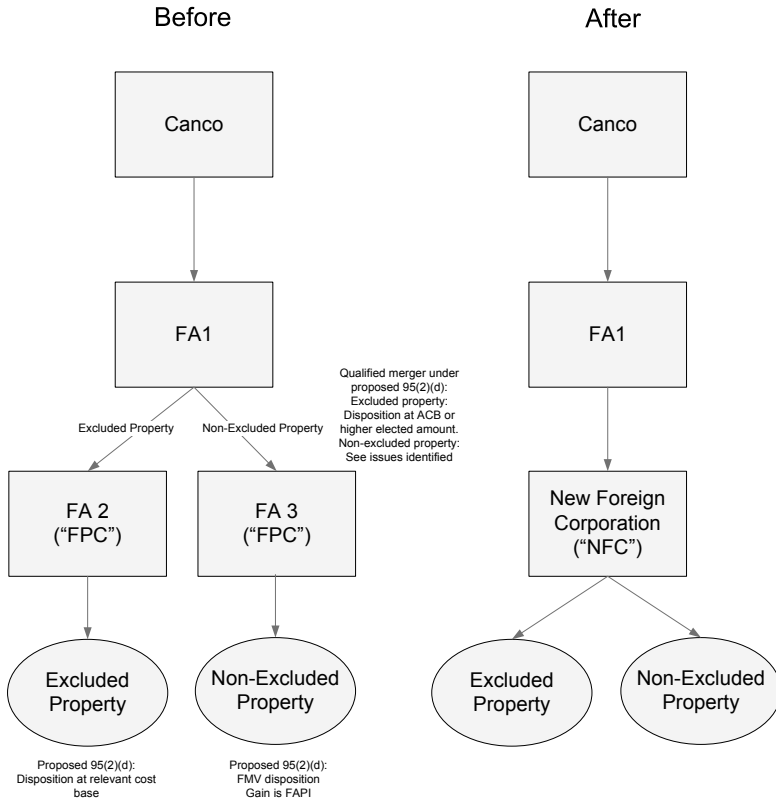
1. Proposed paragraph 95(2)(d) will not apply to a foreign merger to which paragraph 95(2)(d.1) applies, eliminating any overlap between the two paragraphs;
2. Immediately before the foreign merger, each foreign predecessor corporation ("FPC")⁴⁷ must be a foreign affiliate of Canco. As well, the NFC formed as a result of the foreign merger must be a foreign affiliate of Canco. This appears to be an extension of the existing requirement that the shareholder of a PFC ("FA1") be a foreign affiliate of Canco;

3. Each property of a FPC would be deemed to have been disposed of for proceeds of disposition equal to the property's relevant cost base, where the property is excluded property, or the property's fair market value where the property is not excluded property;
4. The NFC's cost of the property would be deemed to be equal to the FPC's proceeds of disposition for the property;
5. Each shareholder of a FPC that is a "specified vendor" in respect of Canco would be deemed to have:
 - a. Disposed of its FPC shares that are excluded property for proceeds of disposition equal to the ACB of the share (unless Canco elects under subclause 95(2)(d)(iii)(A)(II) to recognize higher proceeds of disposition not exceeding the fair market value of the property); and
 - b. Acquired the NFC shares at a cost equal to the deemed proceeds of disposition for the FPC shares;⁴⁸
6. The NFC would be deemed to be the same person as, and a continuation of, the particular FPC for the purposes of paragraphs 95(2)(c.1) through (c.6), (f.3) through (f.93), and (h) through (h.5); and
7. The taxation year of each FPC would be deemed to have ended immediately before the foreign merger.

Proposed paragraph 95(2)(d) would apply to foreign mergers that occur after February 27, 2004. Refer to Figure 8 for a diagrammatic description of proposed paragraph 95(2)(d).

Figure 8

Proposed 95(2)(d)



Issues Arising from Proposed Paragraph 95(2)(d)

Neither existing nor proposed paragraph 95(2)(d) provide any rules specifying how FPC shares that are not excluded property of FA1 are to be treated. In the absence of any other applicable rollover rules, it appears that FA1 would be deemed to have disposed of non-excluded property FPC shares for fair market value proceeds of disposition, and that any resulting gain would be FAPI.⁴⁹ However, it is possible that subsection 87(4) could apply to deem FA1 to have disposed of its non-excluded property FPC shares for proceeds of disposition equal to ACB.

Suppose the FPC owns shares of another foreign affiliate ("FA4"), and those shares are not excluded property. Subparagraph 95(2)(d)(i) would deem the FPC to have disposed of the FA4 shares for fair market value proceeds of disposition. Under proposed subsection 93(1.4), a subsection 93(1) election cannot be made in respect of this particular disposition because subparagraph 95(2)(d)(i) would apply to the disposition. A subsec-

tion 93(1) election would be beneficial to the taxpayer because it could reduce FAPI. This appears to be an inequitable result, especially given the fact that, in a similar upper-tier foreign affiliate transaction, a subsection 93(1) election can be made. For example, under proposed paragraph 88(3)(b) where FA1 distributes FA2 shares that are not excluded property and would otherwise recognize FAPI on the fair market value distribution,⁵⁰ a subsection 93(1) election may be made.

There does not appear to be a definition of the term “specified vendor” for the purposes of proposed paragraph 95(2)(d), however this oversight can likely be easily addressed by making reference to the “specified vendor” definition in either subsection 95(3.2) or (3.5).

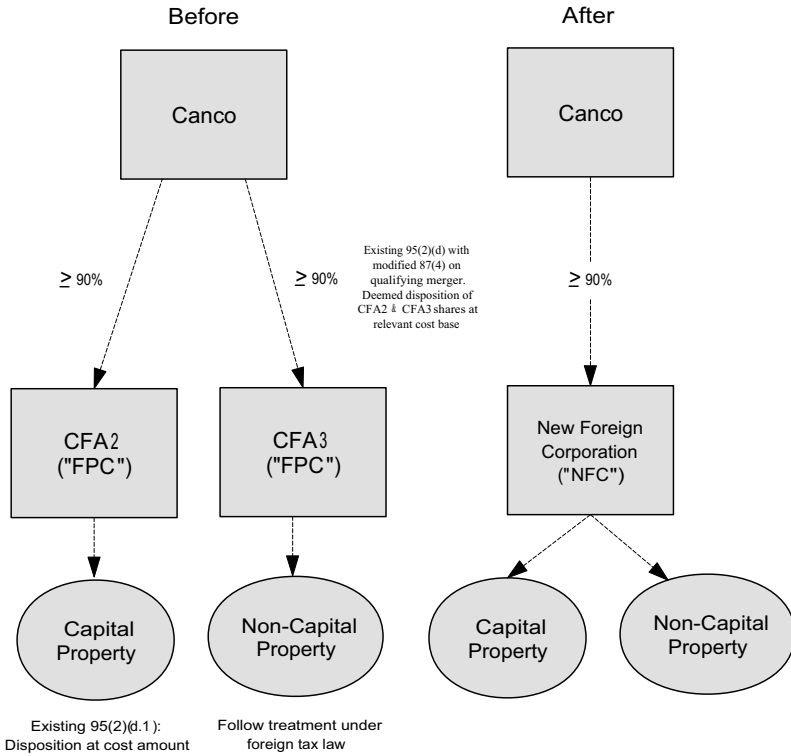
Currently Enacted Paragraph 95(2)(d.1)

Currently enacted paragraph 95(2)(d.1) addresses top-tier foreign affiliate mergers, that is:

1. A foreign merger of two or more PFCs in respect of which a taxpayer’s surplus entitlement percentage (“SEP”) was at least 90% immediately before the merger,
2. To form an NFC in respect of which the taxpayer’s SEP is at least 90% immediately after the merger, and
3. No gain or loss was recognized under the income tax law of the country in which the PFCs were resident immediately before the merger in respect of any capital property of a PFC that became capital property of the NFC in the course of the merger.⁵¹

Where the conditions of existing paragraph 95(2)(d.1) are met, each capital property of a PFC that becomes capital property of the NFC would be deemed to be disposed of for proceeds of disposition equal to the cost amount of the property. Refer to Figure 9 for a diagrammatic description of existing paragraph 95(2)(d.1).

Figure 9
Existing 95(2)(d.1)



Proposed Paragraph 95(2)(d.1) — February 27, 2004

Amendments to paragraph 95(2)(d.1) were first introduced as part of the 2002 Proposals. Under the 2002 Proposals, rollover treatment under paragraph 95(2)(d.1) was expanded to include a rollover for all property, not just capital property. As well, the foreign tax law non-recognition condition was expanded to include any income, gain or loss recognized in respect of any property, not just capital property.

Paragraph 95(2)(d.1) was further amended in the 2004 Proposals to include the following:

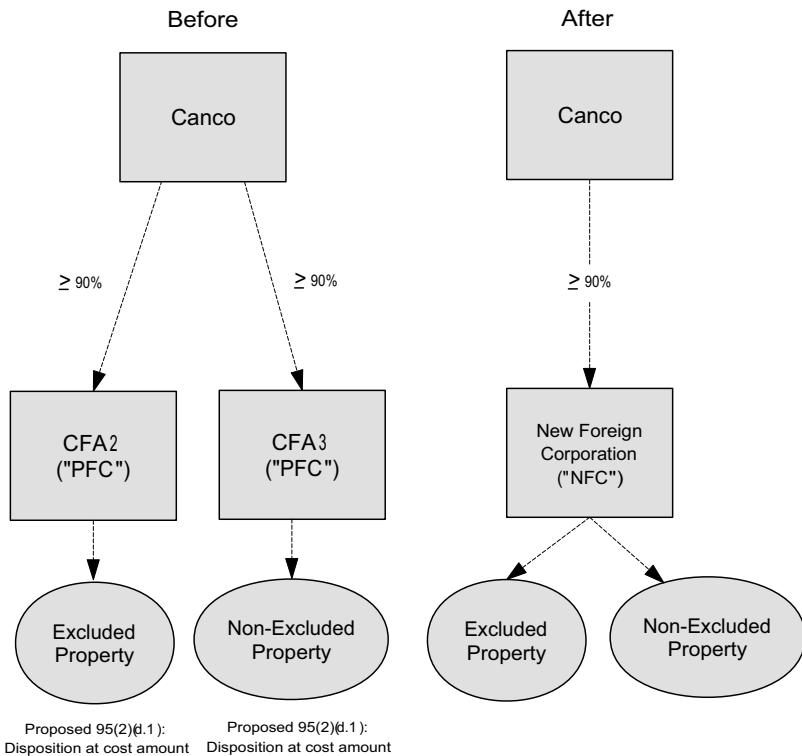
1. A new subparagraph deeming the NFC to be the same person as, and a continuation of, the particular PFC for the purposes of subsection 95(2), the definition of FAPI, and paragraphs 95(2)(c.1) through (c.6), (f.3) through (f.93), and (h) through (h.5); and

2. A new provision to make subsection 87(4) applicable, with modifications, to each foreign affiliate of the taxpayer that, immediately before the merger, owned shares of a PFC.

As well, proposed subsection 93(1.4) would deny the ability to make a subsection 93(1) election where proposed subparagraph 95(2)(d.1)(i) applies.

Both the 2002 and 2004 amendments to paragraph 95(2)(d.1) would be applicable to foreign mergers that occur after December 20, 2002. Refer to Figure 10 for a diagrammatic description of proposed paragraph 95(2)(d.1).

Figure 10
Existing 95(2)(d.1)



Issues Arising from Proposed Paragraph 95(2)(d.1)

The Joint Committee, in a submission to Finance on the 2004 Proposals, noted that there are a number of anomalies that can arise when using SEP, since SEP is not always an accurate measurement of a taxpayer's relationship with its foreign affiliate. In addition, the use of SEP as an ownership

threshold is not consistent with most other sections of the Act (including section 87 amalgamations). The Joint Committee recommended that the SEP threshold be replaced with a different threshold, for example, a qualifying interest or related party threshold, which would be similar to the thresholds used in paragraph 95(2)(a).

Proposed paragraph 95(2)(d.1) would not apply to foreign mergers where any income, gain or loss from the disposition of any property of a PFC (that became property of the NFC) was recognized under the income tax law of the country in which the PFCs were resident. A literal reading of this provision indicates that the PFCs must be resident in the same country, thus excluding cross-border foreign affiliate mergers.

Unlike proposed paragraph 95(2)(d), proposed paragraph 95(2)(d.1) does not deem a PFC's proceeds of disposition to be equal to the relevant cost base of its excluded property. Consequently, an election cannot be made for the PFC to recognize income or gain from the deemed disposition of its excluded property upon the merger. The reason for this inconsistency is not apparent.

An issue that was identified for proposed paragraph 95(2)(f.4) equally applies to proposed 95(2)(d.1). In both proposed paragraphs, the foreign affiliate would be deemed to have disposed of excluded property for proceeds of disposition equal to the ACB of the property (or a greater amount if elected). Where the excluded property is depreciable property, the ACB of the property could exceed another relevant cost amount of the property, for example, undepreciated capital cost. The resulting recapture would be FAPI, notwithstanding that the recapture would be in respect of excluded property. It is possible that the June 6, 2006 comfort letter, discussed above with respect to proposed paragraph 95(2)(f.4), would also apply to proposed paragraph 95(2)(d.1).

As with proposed paragraph 95(2)(d), there does not appear to be a definition of the term "specified vendor" for the purposes of proposed paragraph 95(2)(d.1), however this oversight can likely be easily addressed by making reference to the "specified vendor" definition in either subsection 95(3.2) or (3.5).

June 9, 2006 Comfort Letter

Finance issued a comfort letter on June 9, 2006 to announce the following seven substantial changes to proposed paragraph 95(2)(d.1):

1. The 90% SEP requirement, as well as the foreign tax law non-recognition requirement, would no longer be preconditions to the application of proposed paragraph 95(2)(d.1). Finance appears to have adopted the Joint Committee's recommendation on this matter.

New requirements have been introduced so that proposed paragraph 95(2)(d.1) would not apply unless:

- a. A “specified vendor” (as defined in proposed subsection 95(3.2)) in respect of the taxpayer resident in Canada (“Canco”) was, immediately before the foreign merger, a PFC or a shareholder of a PFC; and
 - b. The NFC formed on the merger was, immediately after the merger, a “specified purchaser” (as defined in proposed subsection 95(3.2)) in respect of Canco.
2. Further, proposed paragraph 95(2)(d.1) would not apply unless the shares of each PFC that, in the course of the foreign merger, are exchanged for or become shares of the NFC (or the foreign parent corporation) have a total fair market value equal to at least 90% of the total fair market value of all shares of the PFC⁵² that are issued and outstanding shares of the PFC immediately before the merger.
 3. Where a PFC is a specified vendor and the NFC is a specified purchaser, each property of the NFC that was a property of a PFC would be deemed to have been disposed of by the PFC for proceeds of disposition, and acquired by the NFC at a cost, equal to:
 - a. Where the property is excluded property, the PFC’s “relevant cost base” of the property;
 - b. Where the property is not excluded property and there is an accrued loss in the property, the PFC’s “relevant cost amount” of the property; and
 - c. In any other case, the PFC’s relevant cost base of the property.

Refer back to proposed amendments to subsection 88(3), where any non-excluded property with an accrued gain would be disposed of for fair market value proceeds, thereby triggering FAPI, while any non-excluded property with an accrued loss would be disposed of for the relevant cost amount of that property, thereby preventing the recognition of a FAPL. Fortunately for taxpayers, this inequitable result does not appear to be repeated in proposed amendments to paragraph 95(2)(d.1), where both FAPI and FAPLs can be avoided.

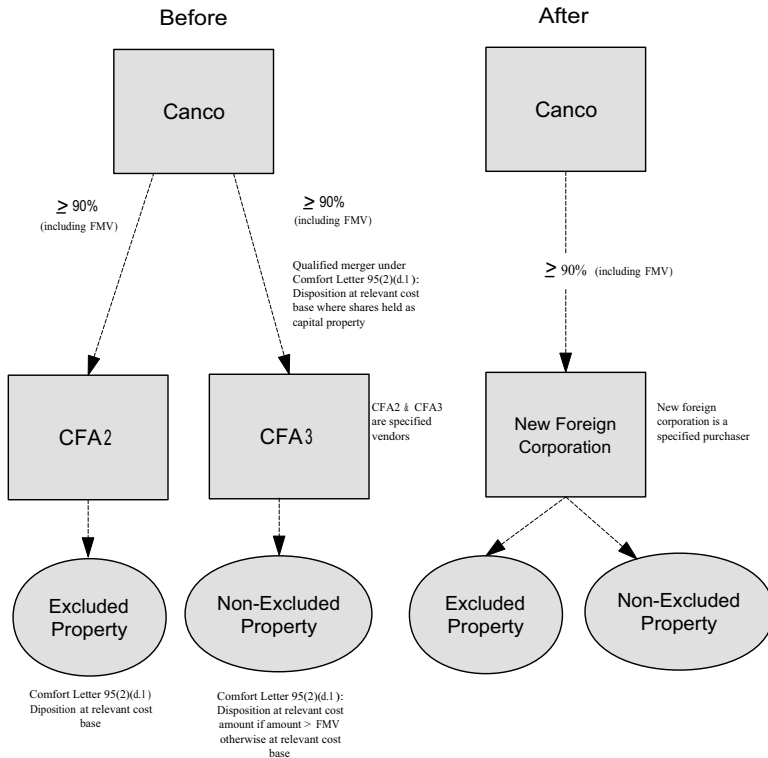
4. Where a PFC is not a specified vendor in respect of Canco, and the NFC is a specified purchaser in respect of Canco, then each property of the PFC would be deemed to be acquired by the NFC at a cost equal to the fair market value of the property. Presumably, the PFC would be deemed to have disposed of each of its properties for fair market value proceeds of disposition, which could give rise to FAPI for non-excluded properties. However, since the PFC is not a specified vendor in respect of Canco, it would be unlikely that the PFC would be a controlled foreign affiliate of Canco, thereby making any resulting FAPI not immediately taxable to Canco.

5. Where the specified vendor holds shares of a PFC immediately before the foreign merger, proposed paragraph 95(2)(d.1) would be modified so that subsection 87(4) would apply (with modifications).
6. Any income or profits tax paid or refunded to a PFC that is a specified vendor in respect of Canco in respect of income, gains or losses that arise from dispositions of property under foreign tax laws, would not be considered income or profit taxes paid by or refunded to the PFC, unless the income, gains or losses are included in the PFC's exempt or taxable earnings.
7. Rules in section 95 would be modified so that, in applying proposed paragraph 95(2)(d.1):
 - a. The PFC's "relevant cost amount" of a distributed property would be essentially the amount that would not result in a gain or loss to the PFC in respect of the distribution; and
 - b. The PFC's "relevant cost base" of the distributed property would be essentially the greater of:
 - i. The PFC's relevant cost amount of the distributed property; and
 - ii. Where the PFC is a controlled foreign affiliate of Canco, the amount elected by Canco, up to the fair market value of the property.

Refer to Figure 11 for a diagrammatic description of proposed paragraph 95(2)(d.1), as modified by the June 9, 2006 comfort letter.

Figure 11

Proposed 95(2)(d.1)
(with June 9, 2006
comfort letter
modifications)



Finance indicated that these modifications would be effective for foreign mergers that occur after December 20, 2002. However, a taxpayer could opt out of having the first modification described above apply (i.e., repeal of the 90% SEP requirement and introduction of the specified vendor and specified purchaser requirements) in respect of all foreign mergers of all of its foreign affiliates during a transition period.

Foreign Affiliate to Foreign Affiliate Liquidations

Paragraphs 95(2)(e) and (e.1) apply where a lower-tier foreign affiliate liquidates and dissolves into an upper-tier foreign affiliate. These paragraphs contain rules that are conceptually similar to subsection 88(3), which addresses liquidations and dissolutions of a top-tier foreign affiliate into its Canadian shareholder.

Currently Enacted Paragraph 95(2)(e)

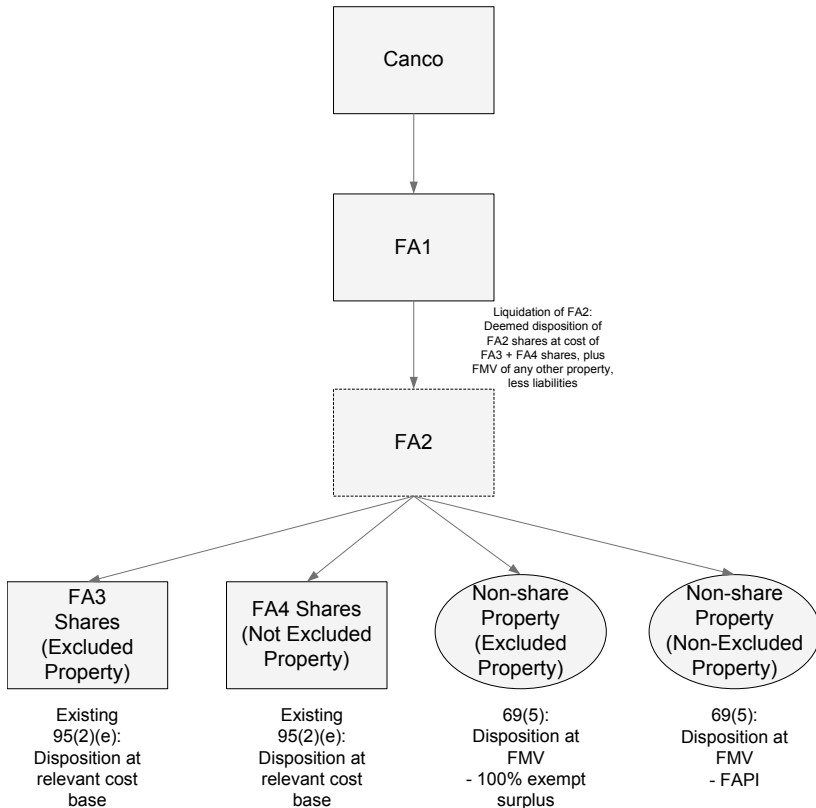
Currently enacted paragraph 95(2)(e) applies where, on the dissolution of a foreign affiliate (“FA2”) of a taxpayer (“Canco”), shares of another foreign affiliate (“FA3”) have been disposed of to a shareholder that is another foreign affiliate (“FA1”). Existing paragraph 95(2)(e) would apply only if existing paragraph 95(2)(e.1) does not apply.

When existing paragraph 95(2)(e) applies, FA2’s proceeds of disposition for the FA3 shares, as well as FA1’s cost of the FA3 shares, would be deemed to equal the relevant cost base of those shares, such that a greater amount of proceeds of disposition, up to the fair market value of the FA3 shares, could be elected. Subsection 69(5) would apply to deem all other property distributed by FA2 to FA1 to be distributed at fair market value. FA1’s proceeds of disposition for the FA2 shares would be deemed to equal the sum of (1) FA1’s ACB of the FA3 shares, and (2) the fair market value of any other net assets (i.e., assets less assumed or cancelled liabilities) of FA2. Any gain recognized by either FA1 or FA2 under paragraph 95(2)(e) would be FAPI,⁵³ whether or not the property they disposed of is excluded property.

Refer to Figure 12 for a diagrammatic description of existing paragraph 95(2)(e).

Figure 12

Existing 95(2)(e)

**Proposed Paragraph 95(2)(e) — February 27, 2004**

Paragraph 95(2)(e), as proposed in the February 27, 2004 draft legislation, contains the following substantial amendments:

1. Proposed paragraph 95(2)(e) would now apply when a “specified purchaser”⁵⁴ in respect of a corporation resident in Canada (“Canco”) receives property from a dissolving foreign affiliate (“FA2”) in the course of a liquidation and dissolution, other than in a liquidation and dissolution to which paragraph 95(2)(e.1) applies. As a result, the shareholder of FA2 need no longer be a foreign affiliate of Canco.
2. Proposed paragraph 95(2)(e) has been broadened to provide rollover treatment (at relevant cost base, with the accompanying election to recognize proceeds of disposition up to fair market value) for both share and non-share property distributed by FA2 to the specified purchaser, but only if the property is excluded property. All other

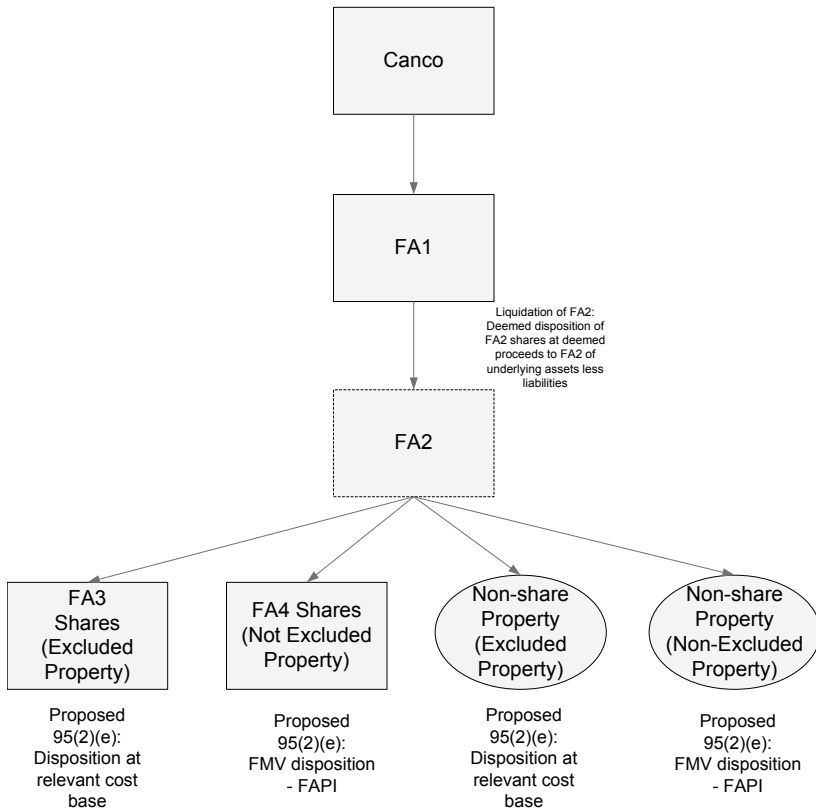
non-excluded property would be deemed to be disposed of at fair market value.

3. A rule has been introduced in proposed subparagraph 95(2)(e)(v) that would apply where the specified purchaser recognizes a gain from the disposition of the FA2 shares in the course of FA2's liquidation and dissolution, and the FA2 shares were excluded property of the specified purchaser. The new rule allows Canco to elect a smaller amount of gain, or no gain at all, but does not allow Canco to recognize a loss. Any remaining gain would be FAPI.⁵⁵

Under both existing and proposed paragraph 95(2)(e), subsection 93(1.1) would deem a subsection 93(1) election to have been made in respect of FA1's (or the specified purchaser's) disposition of its FA2 shares. However, proposed subsection 93(1.4) would deny a subsection 93(1) election in respect of FA2's disposition of any FA3 shares.

Refer to Figure 13 for a diagrammatic description of proposed paragraph 95(2)(e). Proposed paragraph 95(2)(e) would be applicable to liquidations beginning after February 27, 2004.

Figure 13
Proposed 95(2)(e)



Issues Arising from Proposed Paragraph 95(2)(e)

Subsection 93(1.4) would deny the ability to make a subsection 93(1) election to reduce FA2's FAPI where, under proposed paragraph 95(2)(e), FA2 distributes FA3 shares (that are not excluded property) to FA1. However, subsection 93(1.4) would not deny the ability to make a subsection 93(1) election to reduce FA1's FAPI where, under proposed paragraph 88(3)(b), FA1 distributes FA2 shares (that are not excluded property) to Canco. There is no apparent reason for this discrepancy between two relatively similar transactions.

The Joint Committee identified a situation in which FAPI could inappropriately arise. Assume that FA1 owns FA2, and FA2 carries on an active business such that its shares are excluded property of FA1. FA2 makes a liquidating distribution of all of its assets to FA1, but does not legally dissolve. At a later time, FA1 disposes of its FA2 shares upon the formal dissolution of FA2. Proposed subparagraph 95(2)(e)(iv) would determine

FA1's proceeds of disposition for the FA2 shares, which could result in a gain for FA1 that would be FAPI. However, proposed subparagraph 95(2)(e)(v) would not be available to reduce or eliminate this FAPI because at the time that FA1 disposes of its FA2 shares, those shares would not be excluded property.

Arguably, it is inequitable to require taxpayers to elect (under proposed subparagraph 95(2)(e)(v)) to reduce FAPI that would otherwise be recognized on excluded property under proposed subparagraph 95(2)(e)(iv), given that one of the general themes present throughout the foreign affiliate rules is that gains on excluded property are not FAPI unless the taxpayer elects so.

Currently Enacted Paragraph 95(2)(e.1)

Currently enacted paragraph 95(2)(e.1) applies where the following conditions are met:

1. There is a liquidation and dissolution of a foreign affiliate ("FA2") in which the taxpayer's ("Canco's") SEP is at least 90% immediately before the liquidation; and
2. No gain or loss was recognized under the income tax law of the country in which FA2 was resident immediately before the liquidation, in respect of any capital property distributed by FA2 in the course of the liquidation to another foreign affiliate of Canco ("FA1") resident in the same country.

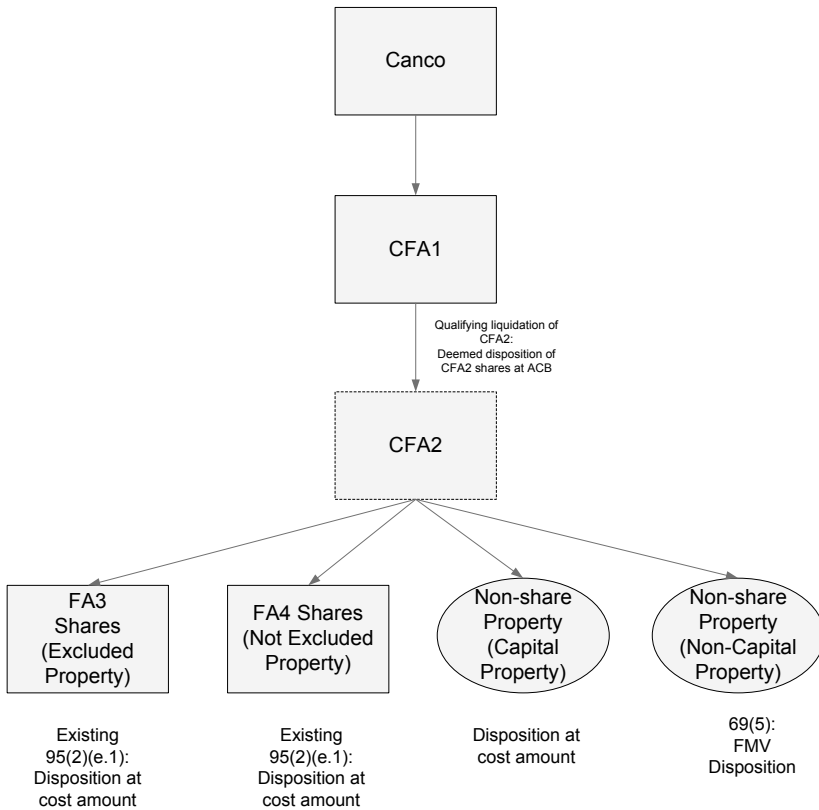
When these conditions are met, existing paragraph 95(2)(e.1) overrides the application of existing paragraph 95(2)(e) and provides the following consequences:

1. Each capital property of FA2 that is disposed of to FA1 would be deemed to have been disposed of for proceeds of disposition equal to the cost amount of the property. Subsection 69(5) would apply to deem all non-capital property distributed by FA2 to FA1 to be distributed at fair market value;
2. The FA2 shares held by FA1 would be deemed to be disposed of for proceeds of disposition equal to the ACB of the FA2 shares; and
3. Under existing Regulation 5905(7), FA2's surplus balances would be transferred to FA1.

Refer to Figure 14 for a diagrammatic description of existing paragraph 95(2)(e.1).

Figure 14

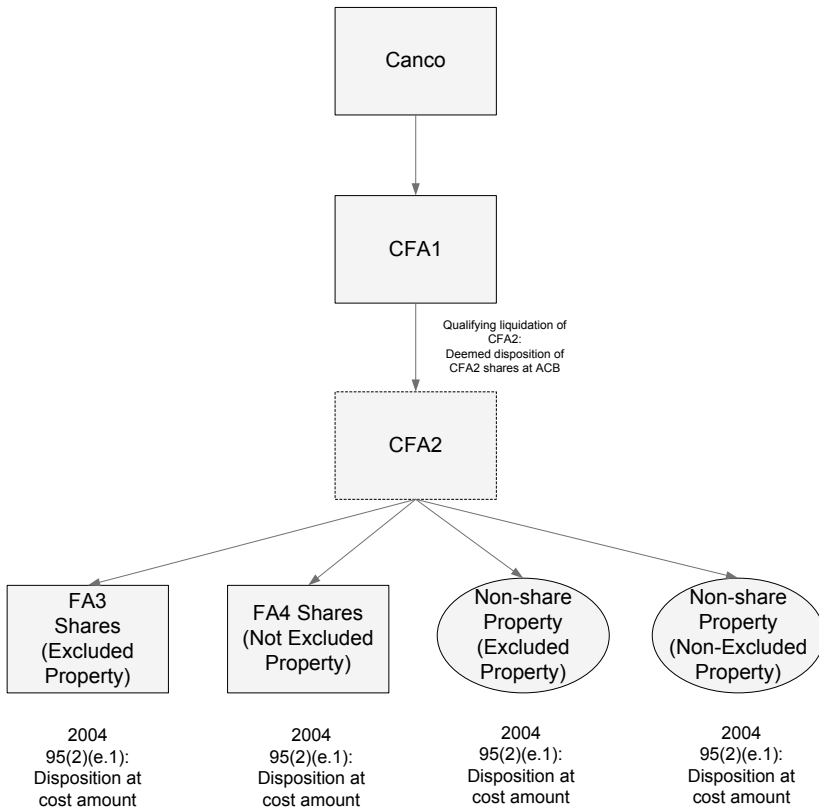
Existing 95(2)(e.1)



Proposed Paragraph 95(2)(e.1) — February 27, 2004

Rules amending paragraph 95(2)(e.1) were initially introduced in the December 20, 2002 proposals. Under these proposals, rollover treatment was expanded to all property of FA2, not just capital property. The foreign tax law non-recognition requirement was also expanded so that no income, gain or loss could be recognized in respect of any property, not just capital property. As well, the requirement that FA1 and FA2 be resident in the same country was eliminated.⁵⁶ Refer to Figure 15 for a diagrammatic description of proposed paragraph 95(2)(e.1).

Figure 15
Proposed 95(2)(e.1)



The February 27, 2004 proposals made a minor change to the 2002 version of paragraph 95(2)(e.1). FA1 would be deemed to be the same corporation as, and a continuation of, FA2 for purposes of paragraphs 95(2)(c.1) through (c.6), (f:1) through (f:93), and (h) through (h.5). As well, proposed subsection 93(1.4) would deny the ability to make a subsection 93(1) election where proposed subparagraph 95(2)(e.1)(i) applies.

Both the 2002 Proposals and 2004 Proposals to amend paragraph 95(2)(e.1) would be applicable to foreign liquidations that begin after December 20, 2002.

Issues Arising from Proposed Paragraph 95(2)(e.1)

Some of the issues identified and discussed above for proposed paragraph 95(2)(d.1) apply equally to proposed paragraph 95(2)(e.1), including the potential anomalies of using an SEP threshold, and the fact that there would be an automatic rollover of all FA2 property, without the ability to

elect to recognize a gain. In addition, proposed paragraph 95(2)(e.1) would apply to foreign tax-free cross-border liquidations, but it would not apply to cross-border liquidations that are taxable under FA2's foreign tax law.

April 12, 2006 Comfort Letter

In the same April 12, 2006 comfort letter that addressed 2004 subsection 88(3), Finance announced the following modifications to proposed paragraph 95(2)(e.1):

1. The foreign tax law non-recognition requirement would be eliminated.
2. Proposed paragraph 95(2)(e.1) would apply where one of the following two tests is met:
 - a. The taxpayer ("Canco") has at least a 90% SEP in respect of FA2 (on the assumption that shares of non-resident corporations owned by any Canadian resident taxpayers related to Canco (otherwise than by virtue of paragraph 251(5)(b)) were attributed to Canco); or
 - b. FA1 has at least a 90% fair market value participating equity interest in FA2. This test would be met if the total fair market value of the FA2 properties distributed in the course of its liquidation and dissolution to FA1 was at least 90% of the total fair market value of all properties distributed by FA2 to all of its shareholders.
3. Where proposed paragraph 95(2)(e.1) applies, it would provide that:
 - a. FA2 would be deemed to have disposed of each property distributed, in the course of the liquidation and dissolution, to a shareholder of FA2 that was, immediately before the distribution, a "specified purchaser" (within the meaning assigned by subsection 95(3.3)) in respect of Canco ("FA1") for proceeds of disposition equal to the greater of:
 - i. FA2's "relevant cost amount" of the distributed property, being essentially the amount that would generally result in no gain or loss to FA2 from the disposition of the distributed property; and
 - ii. Where FA2 is a controlled foreign affiliate of Canco, the amount elected by Canco, but not exceeding the fair market value of the particular distributed property.
 - b. Any gain recognized by FA1 under subsection 40(3) from the disposition of FA2 shares that were redeemed, acquired or cancelled by FA2 in the course of its liquidation and the dissolution would be deemed to be nil;
 - c. The amounts required to be determined under proposed paragraph 95(2)(e.1) would be determined in Canadian dollars where those amounts are relevant for determining FAPI; and

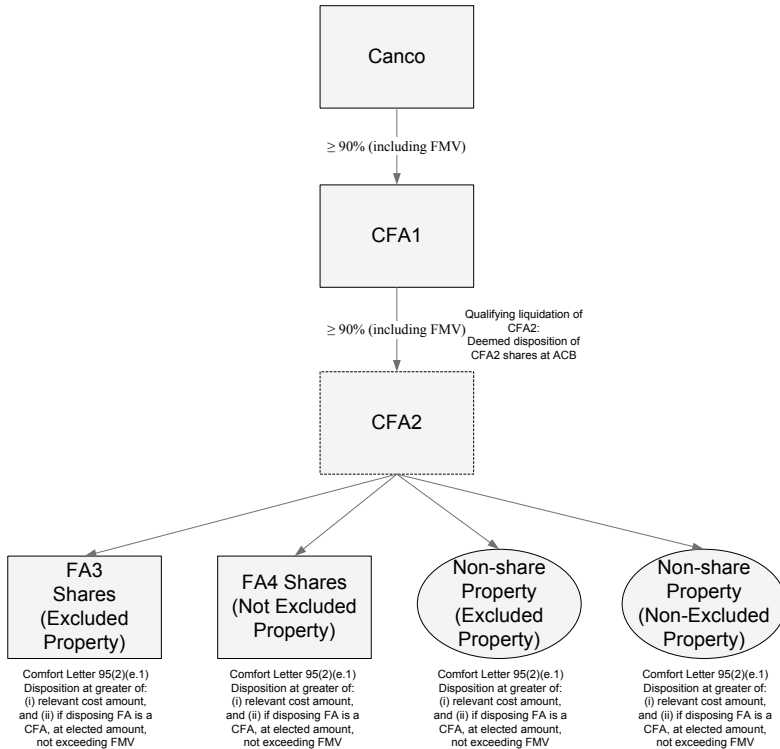
- d. The new FPUC rules described for subsection 88(3) in the April 12, 2006 comfort letter would apply to paragraph 95(2)(e.1), with necessary changes to fit the context of the shareholders of FA2 being specified purchasers in respect of Canco (FA1), rather than Canco itself.
4. Proposed paragraph 95(2)(e.1) would apply (except to the extent that subsection 88(3) applies), to FA1 and FA2 for the purpose of computing FAPI, surplus, foreign tax accounts and FPUC.

These modifications to proposed paragraph 95(2)(e.1) would apply to a liquidation and dissolution of a foreign affiliate that begins after December 20, 2002, except if the taxpayer makes an election that applies in respect of all liquidations and dissolutions of its foreign affiliates. If the taxpayer makes this election, generally the proposals issued on February 27, 2004 would apply instead.

Refer to Figure 16 for a diagrammatic description of proposed paragraph 95(2)(e.1), as modified by the April 12, 2006 comfort letter.

Figure 16

Proposed 95(2)(e.1)
(with April 12, 2006
comfort letter
modifications)



Foreign Affiliate to Foreign Affiliate Distributions

Under existing rules, any distribution of property by a distributing foreign affiliate (“FA2”) to a shareholder foreign affiliate (“FA1”) by way of a dividend, distribution or redemption would be considered to occur at fair market value.⁵⁷ Where FA2 distributes property that is not excluded property at a gain, the gain would be FAPI.

The February 27, 2004 draft legislation proposed new paragraphs 95(2)(e.3) through (e.5)⁵⁸ to introduce new rules to govern distributions made between foreign affiliates by way of either: (1) a dividend or distribution in kind, (2) a dividend-like redemption, or (3) a redemption. These new rules would not apply to lower-tier foreign affiliate liquidations and dissolutions, or to foreign affiliate mergers and combinations (i.e., where proposed paragraphs 95(2)(d), (d.1), (e) or (e.1) would apply).

Proposed Paragraph 95(2)(e.3)

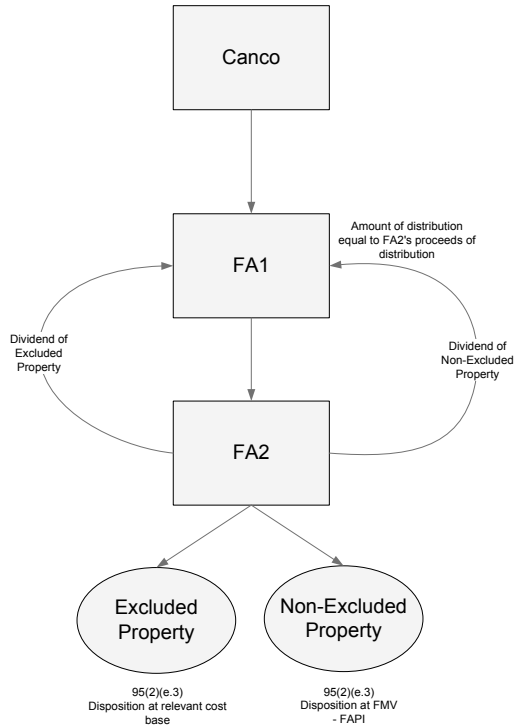
In general, paragraph 95(2)(e.3) would apply where a “specified purchaser”⁵⁹ (“FA1”) of a Canadian corporation (“Canco”) receives property from a distributing foreign affiliate (“FA2”) as a dividend or distribution on the FA2 shares. Where these conditions are met, the following rules would apply:

1. FA2’s proceeds of disposition for the property would be deemed to be:
 - a. Where the property is excluded property, the relevant cost base of the property to FA2; and
 - b. For any other property, the fair market value of the property.
2. The cost to FA1 of the property received from FA2 would be deemed to equal FA2’s proceeds of disposition.
3. The amount of the dividend or distribution would be deemed to equal FA2’s proceeds of disposition.
4. Where the FA2 shares are excluded property, and FA1 would otherwise recognize a gain because of subsection 40(3) (i.e., due to the distribution driving FA1’s ACB in FA2 negative), Canco can make an election to reduce or eliminate the gain, which would otherwise be FAPI.⁶⁰

Refer to Figure 17 for a diagrammatic description of proposed paragraph 95(2)(e.3).

Figure 17

95(2)(e.3)

**Proposed Paragraph 95(2)(e.4)**

Proposed paragraph 95(2)(e.4) would apply where FA1 receives a property from FA2 as consideration for a “dividend-like redemption” of FA2 shares. A “dividend-like redemption” is defined in proposed subsection 95(3.2) to mean a redemption, acquisition or cancellation of FA2 shares where:

1. The FA2 shares are, or would be, excluded property of FA1; and
2. Canco’s SEP in respect of FA2 immediately before the redemption is equal to the Canco’s SEP in respect of FA2 immediately after the redemption.

The consequences that apply to a dividend-like redemption are substantially similar to the consequences in proposed paragraph 95(2)(e.3) that apply to a dividend. In addition, proposed paragraph 95(2)(e.4) provides that the property received by FA1 on the redemption would be deemed to have been received as a dividend, and the amount of the deemed dividend would

be deemed to equal FA2's proceeds of disposition. The surplus ordering rules would apply to this deemed dividend.

Proposed Paragraph 95(2)(e.5)

Proposed paragraph 95(2)(e.5) would apply to a redemption of FA2 shares that is not a "dividend-like redemption". The consequences that apply to such a redemption are substantially similar to the consequences in proposed paragraph 95(2)(e.3) that apply to a dividend. In addition, proposed paragraph 95(2)(e.5) provides that:

1. The property received by FA1 as a result of the redemption would be deemed to be received as proceeds of disposition (rather than as a dividend); and
2. FA1's deemed proceeds of disposition from the redeemed FA2 shares would equal FA1's cost of the property received from FA2 upon the redemption, less any debts or other obligations assumed by FA1 as a consequence of the redemption.

It should be noted that any gains recognized by FA2 under any of proposed paragraphs 95(2)(e.3), (e.4) or (e.5) would be FAPI, and that proposed subsection 93(1.4) would deny the ability to make a subsection 93(1) election in respect of the gain.

Issues Arising from Proposed Paragraphs 95(2)(e.3) through (e.5)

Under currently enacted rules, when FA1 has a negative ACB in its FA2 shares that was caused by a dividend out of FA2's pre-acquisition surplus,⁶¹ subsection 40(3) would apply to include the negative amount as a capital gain to FA1. If the FA2 shares were excluded property, one half of the gain would be added to FA1's exempt surplus, and one half would be added to FA1's taxable surplus. If the FA2 shares were not excluded property, one half of the gain would be FAPI, however a subsection 93(1) election could be made to reduce the gain. The amount of a subsection 40(3) gain would be added to FA1's ACB in the FA2 shares, thereby resetting the ACB to nil.

Under proposed rules, and as discussed above, an election can be made under proposed subparagraph 95(2)(e.3)(iv) to reduce or eliminate the subsection 40(3) gain. However, the election would be made "for the purpose of applying subsection 40(3)"; no other provisions are mentioned. In particular, the election would not be made for the purpose of applying paragraph 53(1)(a), which would add to FA1's ACB in FA2 "any amount deemed by subsection 40(3) to be a gain". Since making the election would result in a lower or nil amount being deemed by subsection 40(3) to be a gain, paragraph 53(1)(a) does not appear to reset FA1's ACB in its FA2 shares to nil.

As a result of this anomaly, it appears that FA1's ACB in its FA2 shares would remain negative for all other purposes of the Act, and would prevent future capital contributions made by FA1 to FA2 from creating a positive

ACB amount until the ACB increases back to nil. Finance has indicated that this result was not intended, that the ACB should be computed in the usual way (i.e., as if there had been a subsection 40(3) gain), and that the wording in the election will be clarified.

As discussed in detail above with respect to proposed paragraph 95(2)(f.4), concerns have been raised over the use of the ACB of a property as the deemed proceeds of disposition. These concerns would equally apply to FA2's distribution of property under proposed paragraph 95(2)(e.3). Where the ACB of the property exceeds another relevant cost amount in respect of the property, e.g., undepreciated capital cost or the foreign equivalent thereof, the deemed proceeds of disposition (assuming the election to recognize FAPI is not made) would exceed that cost amount in respect of the property (e.g., undepreciated capital cost). The resulting recapture would be FAPI, notwithstanding that the recapture would be in respect of excluded property.

In a comfort letter issued on June 6, 2006, Finance noted its intention to recommend modifications to the draft legislation that would eliminate this issue, but did not give substantial details of the modifications, limiting its comments to the following: "The revisions to proposed subparagraphs 95(2)(e.3)(i) and (f.4)(i) would (except where the taxpayer elects otherwise) permit the foreign affiliate to treat its proceeds of disposition in respect of a disposition of an excluded property to be equal to an amount that would result in no immediate income, gain, loss, surplus or deficit in respect of the disposition. The income, gain, loss, surplus or deficit amount that has not been recognized at the time of the disposition would be recognized when the appropriate circumstances occur." Finance anticipates that these revisions would have the same application date as paragraphs 95(2)(e.3), i.e., to transactions occurring after February 27, 2004.

Conclusions on Foreign Affiliate Merger, Liquidation and Distribution Rules

As with many of the foreign affiliate proposals, the proposed foreign affiliate merger, liquidation and distribution rules in proposed paragraphs 95(2)(d) through (e.6) are not yet well settled. Finance has issued numerous comfort letters in an attempt to clarify and/or revise portions of the proposals, including substantial overhauls of proposed paragraphs 95(2)(d.1) and (e.1). Problems have also been identified in proposed paragraph 95(2)(e.3), and Finance has promised to fix those problems. Taxpayers and members of the tax community are waiting to see whether any or all of the revisions made to proposed paragraphs 95(2)(d) through (e.6) will in fact be incorporated in a new set of proposals. It is hoped that new draft legislation will be issued sooner rather than later.

ENDNOTES

¹ R.S.C. 1985, c. 1 (5th Supp.), as amended (the Act). Unless otherwise noted, statutory references in this paper are to the Act or the Income Tax Regulations, C.R.C., c. 945 (1977), as amended (the Regulations).

² Canada, Department of Finance, Legislative Proposals and Explanatory Notes relating to Income Tax (Ottawa: Department of Finance, December 2002), (the “2002 Proposals”).

³ Canada, Department of Finance, Legislative Proposals and Draft Regulations relating to Income Tax (Ottawa: Department of Finance, February 2004), (the “2004 Proposals”).

⁴ Throughout this paper, references to a taxpayer resident in Canada are to a Canadian resident corporation, Canco, and not to a Canadian resident individual.

⁵ Excluded property is defined in subsection 95(1).

⁶ Regulation 5907(1) “net earnings” (d) and “exempt earnings” (a).

⁷ Foreign accrual property income is defined in subsection 95(1).

⁸ Regulation 5907(1) “exempt earnings” (a).

⁹ Proposed subsection 95(1) “foreign accrual property income” paragraph (b) under the definition of “B” in the formula set out therein.

¹⁰ A capital gain would generate 100% exempt surplus provided that the excluded property was used by FAI to earn income from an active business carried on in a designated treaty country (or in Canada). A gain on account of income would generate 100% exempt surplus provided FAI is resident in a designated treaty country and the excluded property was used by FAI to earn income from an active business carried on in a designated treaty country (or in Canada).

¹¹ With respect to dividends, 2004 paragraph 88(3)(d) determines the amount of the dividend, while section 90 requires that Canco include the dividend in its income.

¹² Finance also confirmed in the August 19, 2004 comfort letter that the source of the funds used by FAI to make a return of capital payment to Canco should not affect the application of 2004 subsection 88(3).

¹³ It is assumed that the foreign corporate law governing FAI allows a return of capital payment that exceeds the legal paid-up capital of the shares.

¹⁴ Subsection 92(2).

¹⁵ In the April 12, 2006 comfort letter, discussed later in this paper, a third component is added in determining the proceeds of disposition for each distributed property. This component is equal to the amount of any consideration received by FAI from Canco for the distributed property, which includes Canco’s assumption or settlement of any FAI debts or obligations.

¹⁶ Paragraph 95(2)(f).

¹⁷ The Joint Committee on Taxation is a joint committee of the Canadian Bar Association and the Canadian Institute of Chartered Accountants.

¹⁸ Assuming all ordinary common shares, other than the bonus shares, were issued for cash.

¹⁹ *Supra*, note 6.

²⁰ Subsection 95(1) “foreign accrual property income” component B.

²¹ The February 27, 2004 draft legislation proposes to repeal Regulation 5907(5.1), and replace it with the rules in paragraphs 95(2)(c.2) through (c.6) and paragraphs 95(2)(f.3) through (f.9).

²² Brian Mustard, ‘The February 27, 2004 Draft Proposals on Foreign Affiliates,’ *Report of Proceedings of Fifty-Sixth Tax Conference*, 2004 Tax Conference (Toronto: Canadian Tax Foundation, 2005), 20:1-104, at page 2.

²³ Regulation 5901.

²⁴ Subsection 93(1).

²⁵ Paragraph 55(5)(d).

²⁶ Finance has essentially abandoned the December 20, 2002 version of subsection 93(1.4). However, taxpayers can still elect to apply that version to dispositions that occurred after December 20, 2002 and before February 27, 2004.

²⁷ Proposed subparagraph 95(2)(c.1)(ii) in the 2004 Proposals.

²⁸ Proposed subparagraph 95(2)(c.1)(iii) in the 2004 Proposals.

²⁹ Refer to proposed subparagraph 95(2)(c.1)(iv) in the 2004 Proposals which requires that “none of paragraphs (2)(c), (d) to (e.1) and (e.3) to (e.5) and 88(3)(a) applies to the vendor in respect of the disposition of the share”.

³⁰ Subsection 95(3.2) “specified purchaser”.

³¹ Paragraph (b) under the definition of a “Triggering Disposition” in proposed subsection 95(3.3).

³² Proposed subparagraph 95(2)(c.3)(ii).

³³ Paragraph (c) under the definition of a “Specified Discontinuance” in proposed subsection 95(3.3).

³⁴ The 2004 Proposals repeal Regulation 5907(5.1).

³⁵ The comfort letter also dealt with proposed paragraph 95(2)(e.3) and revisions thereto.

³⁶ *Supra*, note 22 — at page 25.

³⁷ It is not clear whether this suspended surplus approach would in fact be less of an administrative burden to taxpayers than the suspended income and gains approach. However, overall a suspended surplus approach should be favoured by most taxpayers.

³⁸ As defined by subsection 87(8.1) through the application of subsection 95(4.1).

³⁹ *Ibid.*

⁴⁰ *Ibid.*

⁴¹ Defined in subsection 95(4) to equal the ACB to FAI of the property, or such greater amount as the taxpayer claims not exceeding the property’s fair market value at that time.

⁴² Allocated on a *pro rata* basis, based on relative fair market values, where more than one class of shares is received.

⁴³ This conclusion is supported by Advance Income Tax Ruling 2000-0024951, which dealt with an absorptive foreign merger.

⁴⁴ Other than amounts receivable from any PFC, or shares of a PFC.

⁴⁵ Other than amounts payable to any PFC.

⁴⁶ Or shares of the “foreign parent corporation” (defined in subsection 87(8.1)), where the shares of the NFC are controlled by the “foreign parent corporation” after the merger.

⁴⁷ There does not appear to be any particular reason for the change in reference to a “foreign predecessor corporation” from a “predecessor foreign corporation”.

⁴⁸ Allocated on a *pro rata* basis, based on relative fair market values, where more than one class of shares is received.

⁴⁹ Proposed subsection 95(1) “foreign accrual property income” B in the FAPI formula includes gains from the disposition of property other than dispositions of excluded property.

⁵⁰ This issue was noted in the November 3, 2004 Joint Committee submission to Finance on the February 27, 2004 foreign affiliate proposals.

⁵¹ Currently enacted paragraph 95(2)(d.1) could also apply to lower-tier foreign affiliate mergers, since a taxpayer can have a 90% SEP in lower-tier foreign affiliates. The apparent overlap between currently enacted paragraphs 95(2)(d) and (d.1) is addressed in the 2004 proposals, as discussed above.

⁵² Other than shares owned by any PFC that, in the course of the merger, are not exchanged for or become shares of the NFC or the foreign parent corporation.

⁵³ Existing subsection 95(1) “foreign accrual property income” component B in the formula.

⁵⁴ As defined in subsection 95(3.2).

⁵⁵ Proposed subsection 95(1) “foreign accrual property income” paragraph (b) under the definition of “B” in the formula set out therein.

⁵⁶ In addition, new paragraph 95(2)(e.2) has been added to deem certain redemptions, acquisitions or cancellations of FA2 shares to be a liquidation and dissolution of FA2 for purposes of paragraph 95(2)(e.1).

⁵⁷ In particular, subsection 52(2) would apply to dividends.

⁵⁸ Proposed paragraph 95(2)(e.6) provides rules, for the purposes of proposed paragraphs 95(2)(e), (e.3), (e.4) and (e.5), for determining a foreign affiliate’s income from a partnership, where the foreign affiliate is a member of the partnership and that partnership is a shareholder referred to in those paragraphs.

⁵⁹ As defined in subsection 95(3.2).

⁶⁰ Proposed subsection 95(1) “foreign accrual property income” B(c).

⁶¹ The reduction in ACB arising from the pre-acquisition surplus dividend would be pursuant to the application of subsection 92(2) and paragraph 53(2)(b).

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