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CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA
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The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

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August 7th, 2013

Mr. Brian Ernewein
General Director, Tax Legislation Division
Tax Policy Branch
Department of Finance
L'Esplanade, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G5

Re: October 24, 2012 Notice of Ways and Means Motion / Bill C-48, the Technical Amendments Act, 2012

Dear Mr. Ernewein:

Please find enclosed our submission on the provisions of Bill C-48, the Technical Tax Amendments Act, 2012 ("**Bill C-48**"). Bill C-48 implements the proposed amendments reflected in the Notice of Ways and Means Motion tabled in Parliament on October 24, 2012, including proposals that consolidate almost all outstanding tax measures related to foreign affiliates and a significant number of other technical amendments to the Income Tax Act (the "**October 24, 2012 Proposals**").

Our submission is focused principally on the amendments to proposed legislation on "upstream loans" and "foreign tax credit generators". While the October 24, 2012 Proposals have introduced many welcome changes to the upstream loan provisions, including transitional relief for upstream loans outstanding on August 19, 2011, we have encountered numerous issues in the practical application of the rules. In particular, there are many instances where taxpayers may not be entitled to relief under the foreign exchange offset mechanism simply by reason of the use of the words "*is equal to*" in subsection 39(2.1).

The October 24, 2012 Proposals have also introduced improvements to the proposed legislation on "foreign tax credit generators". Nonetheless, the revised legislation appears to apply in some unanticipated circumstances, particularly due to the asymmetrical interaction of the rules with tax legislation in foreign jurisdictions. Further elaboration on these issues is found in the body of the submission along with our recommendations to further improve the proposed legislation.

Several members of the Joint Committee participated in discussions concerning our submission and contributed to its preparation, in particular:

Sandra Slaats (Deloitte LLP)
Bill Brebber (Ernst and Young LLP)

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Angelo Nikolakakis (Couzin Taylor LLP)

We trust that you will find our comments helpful and would be pleased to discuss them with you at your convenience.

Yours very truly,

Penny Woolford
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Darcy D. Moch
Chair, National Taxation Section
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Cc: Gabe Hayos, Vice President, Taxation, CPA Canada

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SUBMISSION

The Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada (the "**Joint Committee**") is pleased to provide this submission on the provisions of Bill C-48.

Our submission discusses certain technical issues under Bill C-48 related to upstream loans, foreign tax credit generators, foreign spin-offs, and anti-avoidance rules.

The following abbreviations are used throughout this submission:

Act	*Income Tax Act*
August 19, 2011 Proposals	The proposals in respect of foreign affiliates released on August 19, 2011
August 27, 2010 Proposals	The proposals implementing the 2010 Federal Budget Measures released on August 27, 2010
Bill C-48	Bill C-48, the Technical Tax Amendments Act, 2012 (at Report Stage)
FA	Foreign affiliate
FAPI	Foreign accrual property income
FAT	Foreign accrual tax
GAAR	General anti-avoidance rule
October 24, 2012 Proposals	The legislative proposals included in the Notice of Ways and Means Motion tabled in Parliament on October 24, 2012

Unless otherwise indicated, all statutory references are to the provisions of the Act as amended by Bill C-48.

1. UPSTREAM LOAN ISSUES

As noted above, the October 24, 2012 Proposals include extensive revisions to the "upstream loan" rules, which were originally released on August 19, 2011. In our original submission (dated October 19, 2011), we identified a considerable number of issues and anomalies with the August 19, 2011 Proposals. Many, although not all, of these issues were addressed by the Department of Finance in the revised rules.

A number of additional issues have been identified in the practical application of the revised rules. These issues, and our recommendations to address these issues, are outlined below. Many of these issues relate to the transitional relief that has been introduced to allow a taxpayer to offset a foreign exchange gain or loss on the repayment of an upstream loan against the related loss or gain of the FA. Furthermore, we reiterate some of our key recommendations from our original submission that were not addressed in the new proposals.

a. Transitional Relief - Loans to Other Non-Arm's length Canadian Corporations

New subsection 39(2.1) of the Act is a temporary measure that sets-off, in certain circumstances, foreign exchange gains or losses of a taxpayer on the repayment of a debt obligation owing to a FA of the taxpayer against the related losses or gains of the FA from the repayment. This provision is intended to provide relief to taxpayers that find it necessary to repay pre-August 19, 2011 upstream loans in order to avoid the application of new subsection 90(6). Paragraph 95(2)(g.04) provides a corresponding rule with respect to the related foreign exchange gain or loss of the FA.

Subsection 90(6) applies where a *"specified debtor"* in respect of a taxpayer receives a loan, or becomes indebted to, a FA of the taxpayer. "*Specified debtor*"[1] includes the taxpayer, and persons with which the taxpayer does not deal at arm's length (other than Canadian controlled FAs). As a result, a taxpayer may have an income inclusion from the application of subsection 90(6) where a loan is provided by a taxpayer's FA to a Canadian company that does not deal at arm's length with the taxpayer.

The application of subsection 39(2.1) is restricted to situations where a capital gain of the FA on the repayment of the debt obligation would be included in computing income of the borrowing party under subsection 91(1). Therefore, no set-off is available where a loan has been advanced by a FA of a taxpayer to a Canadian company that does not deal at arm's length with the taxpayer. In practice, we encounter a number of instances where loans are provided to a Canadian company that is a sister company or a parent company of the taxpayer. In such circumstances, the Canadian sister company or parent company may be forced to repay the upstream loan that was outstanding at August 19, 2011, but the taxpayer will not be entitled to relief under new subsection 39(2.1) (or paragraph 95(2)(g.04)).

[1] Subsection 90(15) of the Act.

For example, assume Canco 2 is a wholly-owned subsidiary of Canco 1. Canco 2 owns 100% of a non-resident corporation, FA. Before August 19, 2011, FA advanced a US Dollar denominated interest-bearing loan to Canco 1. The loan will need to be repaid by August 19, 2016 for Canco 2 to avoid an income inclusion with respect to the upstream loan pursuant to subsection 90(6). Assume that, on repayment of the loan, Canco 1 incurs a foreign exchange gain, and FA incurs a foreign exchange loss. Canco 1 is not entitled to offset the foreign exchange gain with the related loss of the FA.

While not part of the upstream loan rules, subsection 18(8) in the thin capitalization rules has a similar flaw that applies on an upstream loan from a foreign affiliate to a Canadian corporation that does not deal at arm's length with the taxpayer. The relief provided by that provision is only available for loans to the taxpayer.

Recommendation

We recommend that the transitional relief in subsection 39(2.1) and paragraph 95(2)(g.04) be extended to allow a foreign exchange gain or loss incurred by a non-arm's length Canadian corporation of a taxpayer on the repayment of an upstream loan to be offset against the related foreign exchange gain or loss of FA of the taxpayer. We also recommend that subsection 18(8) be similarly amended to extend the relief it provides to loans made to non-arm's length Canadian corporations of a taxpayer.

b. Transitional Relief – Non-Interest Bearing Loans

Subparagraph 40(2)(g)(ii) denies a loss on the disposition of a debt, or other receivable, unless the debt was acquired for the purpose of gaining or producing income from a business or property. Where a non-interest bearing loan is advanced by a FA to its Canadian parent company, any capital loss incurred by the FA on the repayment of the loan could be deemed to be nil pursuant to subparagraph 40(2)(g)(ii), although that may depend on the circumstances.

The issue with upstream loans made on a non-interest bearing basis is that the new subsection 39(2.1) only applies where the taxpayer's gain "*is equal to*" the FA's loss. Where the FA's loss is deemed to be nil pursuant to subparagraph 40(2)(g)(ii), it appears that the requirements of subsection 39(2.1) would not be satisfied, and therefore, the taxpayer's capital gain cannot be reduced.

For example, assume that Canco owns 100% of a non-resident corporation, FA. FA advanced a US dollar denominated debt to Canco on a non-interest bearing basis. On repayment of the loan, Canco incurs a foreign exchange gain of $100, and FA incurs a foreign exchange loss of $100, as computed under Canadian tax rules. FA's capital loss could be deemed to be nil pursuant to subparagraph 40(2)(g)(ii). Canco's capital gain would be $100, and cannot be reduced by the foreign exchange offset rule on the basis that Canco's capital gain of $100 does not equal FA's capital loss of nil. In the absence of subparagraph 40(2)(g)(ii), Canco's capital gain of $100 could be reduced.

The same issue does not arise where Canco incurs a foreign exchange loss, and FA incurs a foreign exchange gain as the loss denial rules do not apply to the settlement.

The policy rationale behind the introduction of new subsection 39(2.1) is to provide relief to taxpayers that are forced to unwind their current "upstream loans", and would otherwise be subject to significant tax consequences relating to foreign exchange. For upstream loans that are non-interest bearing, this relief will not be available. We believe that it is not consistent with the purpose of subsection 39(2.1) that non-interest bearing loans would be denied relief.

Recommendation

We recommend that subsection 39(2.1) and paragraph 95(2)(g.04) be amended to ensure that relief is also available to taxpayers with upstream loans that are non-interest bearing. For example, this could be achieved by inserting the following wording into subsection 39(2.1):

> *"(2.1) If at any time a corporation resident in Canada......is equal to the amount of the creditor affiliate's or creditor partnership's capital* loss or capital gain, *as the case may be, determined, in the absence of paragraph 95(2)(g.04) [**and, where applicable, in the absence of subparagraph 40(2)(g)(ii)]**, in respect of the repayment….*
>
> *(a) in the case of a capital gain*
>
> *(i) if the creditor is a creditor affiliate, by an amount, not exceeding that capital gain, that is equal to twice the amount that would — in the absence of paragraph 95(2)(g.04) [**and, where applicable, in the absence of subparagraph 40(2)(g)(ii)]** ……, or*
>
> *(ii) if the creditor is a creditor partnership, by an amount, not exceeding that capital gain, that is equal to twice the amount that is the total of each amount, determined in respect of a particular member of the creditor partnership that is a foreign affiliate of the borrowing party, that would — in the absence of paragraph 95(2)(g.04) [**and, where applicable, in the absence of subparagraph 40(2)(g)(ii)]**……."*

Consistent wording should be inserted into paragraph 95(2)(g.04) to ensure that the borrower party's capital gain is equal to the creditor affiliate's capital loss as computed without reference to the loss denial rules.

c. Transitional Relief - Acquisition of Control

As noted above, subsection 39(2.1) only applies where the taxpayer's gain "*is equal to*" the FA's loss, or the taxpayer's loss is equal to the FA's gain. There are situations where the taxpayer's foreign exchange gain or loss is not equal to the FA's gain or loss because of, for example, an acquisition of control.

As a result of an acquisition of control, a corporation must recognize all its accrued capital losses on its property under 111(4). As capital losses expire on an acquisition of control, a corporation may elect to realize certain accrued gains on other property that it owns to use some of these crystallized capital losses. Subsection 111(12) extends this treatment to accrued gains or losses on debts of a taxpayer that arise from foreign exchange fluctuations. Thus, a taxpayer may have recognized an accrued capital gain or loss on an upstream loan, and the adjusted cost base of the upstream loan may have been adjusted to the fair market value, or to another designated amount, of the loan at the time immediately before an acquisition of control. As a result of these rules, the taxpayer's capital gain or loss realized on repayment of the debt could be different from what it would have been where no acquisition of control took place. Since the FA would not be subject to these rules, the taxpayer's capital gain or loss would not be equal to the FA's capital gain or loss.

Recommendation

We recommend that subsection 39(2.1) and paragraph 95(2)(g.04) be modified to generally permit the offset mechanism to apply even where the taxpayer's capital gain or loss does not equal the creditor affiliate's capital gain or loss. We believe the legislation can be drafted in a manner that ensures that the reduction in the capital gain of the taxpayer, or the FAPI, is restricted to the amount of the related FACL, or capital loss.

d. Transitional Relief - Loans on Income Account

The relief provided under subsection 39(2.1) and paragraph 95(2)(g.04) is only available to the extent the gain or loss is a capital gain or capital loss to the borrower and to the lender. It is unclear why the relief should not be available to the extent the gain or loss is on income account.

Recommendation

Extend the provisions to capture circumstances where the gain or loss is on income account.

e. Back-to-Back Loans – Loan Repayment

New subsection 90(7) collapses back-to-back loans into one loan. This rule operates iteratively so that multiple loans may, in appropriate circumstances, all be collapsed into one loan. This rule has been introduced to prevent multiple income inclusions where the same funds are lent "back-to-back" within a related FA group.

For example, Canco owns three FAs, FA1, FA2 and FA3. FA1 lends $100 to FA2; FA2 lends $100 to FA3, and FA3 lends $100 to Canco. Subsection 90(7) is applied twice, and the three separate loans are deemed to be one loan made by FA1 to Canco of $100. The separate loans are deemed not to have been made, by virtue of paragraph 90(7)(b).

Paragraph 90(8)(a) avoids an income inclusion under subsection 90(6) where loans or indebtedness are repaid within two years. Similarly, subsection 90(14) provides a deduction where an amount has been included in income under subsection 90(6) when the related debt is repaid. In the above scenario, it is unclear at what time the deemed loan from FA1 to Canco would be considered to be "repaid" for the purposes of subsections 90(8) and (14). There is no provision that deems the deemed loan to be repaid when the actual loans are repaid.

Recommendation

We recommend that a new subsection be included to deem that the repayment date of the deemed loan, pursuant to subsection 90(7), to occur when the actual loans have been repaid, to the extent of the repayment.

f. Upstream Loans – Offset Mechanism for Foreign Exchange

From a commercial perspective, upstream loans are frequently used between Canadian parent companies and their US subsidiaries to satisfy short-term working capital requirements of the Canadian parent company. Where the debt is denominated in US dollars, the repayment of the debt can give rise to FAPI or FACL in respect of the US subsidiary. Additionally, the Canadian corporation would realize a capital gain or capital loss in respect of the same debt. Fluctuations in the value of the US Dollar would have the opposite effect on the lender and the borrower, and normally, the capital gain or loss of the Canadian corporation will match the FACL or FAPI of the US subsidiary exactly. With the exception of the transitional measures included in subsection 39(2.1), the Canadian taxpayer cannot utilize its capital loss against the FAPI of the US subsidiary, or vice versa.

Upstream loans are often made for legitimate commercial reasons, and can be denominated in a foreign currency due to foreign legal or tax reasons. Irrespective of whether the foreign currency appreciates or depreciates against the Canadian dollar, the Canadian taxpayer may be subject to corporate income taxes on the movement of the foreign currency. If you consider the overall impact on a Canadian headquartered group, the net foreign exchange gain or loss would be nil, yet the Canadian entity may be subject to income taxes. In our view, this is an inappropriate outcome.

We believe that Canadian taxpayers should be entitled to offset foreign exchange gains or losses on the repayment of a debt obligation owing to a FA against the related losses or gains of the FA.

Recommendation

We recommend that the Department of Finance consider the introduction of some form of permanent relieving provision with respect to foreign exchange movements on upstream loans.

g. *Foreign Exchange Consequences of Upstream Loans and the Interaction with Surplus Calculating Currency*

In certain cases, taxpayers have made upstream loans in lieu of paying dividends because amendments that would materially affect the determination of surplus had not yet been proposed, or they were the subject of comfort letters but no proposed legislation had been drafted, or they had been proposed but were subject to significant debate and uncertainty. Further, where the proposals had not progressed to enactment or substantial enactment, reliance on the proposed legislation would have resulted in significant and often material financial statement consequences.

For all of these reasons, often the only reasonable alternative for many taxpayers to repatriate earnings was to rely on the CRA's long-standing administrative practice regarding upstream loans. Further, to avoid the potential FAPI implications arising from foreign currency upstream loans, taxpayers often denominated their upstream loans in Canadian dollars. Until recently, taxpayers have been unable to maintain their surplus accounts in Canadian dollars. The recent amendments to ITR 5907(6) change this, but only for taxation years beginning after December 18, 2009, and only where the taxpayer can demonstrate that using Canadian dollars is "reasonable in the circumstances".

The Canadian dollar has appreciated significantly in recent years against several foreign currencies, and in particular, the U.S. dollar. Where taxpayers have made Canadian dollar upstream loans of their surplus, the strengthening Canadian dollar has resulted in a significant shortfall in U.S. dollar surplus terms. The consequences of this shortfall will be Canadian tax on the ultimate repayment or inclusion under subsection 90(6) of the upstream loan, even though the taxpayer has made no net economic gain. By way of example, if a foreign affiliate had US$100 of exempt surplus at the end of 2004 and lent the US$100 to the taxpayer in Canadian dollars, the loan would have been C$121. If repaid as an exempt surplus dividend in 2011 when the Canadian dollar is at par, there is a C$21 shortfall.

Furthermore, for loans outstanding on August 19, 2011, the transitional rules provide that these amounts are deemed to be a separate loan that was received on August 19, 2011, and hence all the related rules, and in particular the measurement of available surplus relevant for subsection 90(9)(a), should be made as of that date.

This rule may give rise to a mismatch between the loan amount and available surplus balances. In particular, upstream loans are often made in Canadian dollars to avoid foreign exchange issues, while the underlying surplus balances are maintained in local currency. If the Canadian dollar appreciated between the time the loan was made and August 19, 2011, there may be insufficient exempt surplus to fully cover the loan, even though sufficient surplus existed at the time the loan was made.

This issue is parallel to the issue that arises in a context where an upstream loan was denominated in a foreign currency, which is addressed by subsection 39(2.1) and paragraph 95(2)(g.04).

Recommendation

We recommend that Finance amend the Act to allow taxpayers to elect to treat some or all of an upstream loan as a deemed dividend paid at the time of the advance, the amount of which is added to the adjusted cost base of the shares of the particular top-tier foreign affiliate. The portion of the loan(s) so elected would then be excluded from the application of subsection 90(6). Taxpayers should be able to elect to apply the amendment for taxation years commencing after 1994. For loans outstanding as at August 19, 2011, the rules should clarify that the elected deemed dividend would occur at the time the advance was actually made and not on August 19, 2011.

h. Reserve for Previously-Taxed FAPI

Subsection 90(9) provides a reserve in respect of amounts included in income under subsection 90(6). The reserve relates to amounts that would have been deductible to the taxpayer if, in general, the amount of the upstream loan had been paid to the taxpayer, instead, as a dividend or dividends. Clause 90(9)(a)(i)(D) provides a deduction for amounts that would have been deductible under paragraph 113(1)(d), to the extent of the adjusted cost base of the shares, except where the upstream loan is made to a non-resident borrower or borrowers. For upstream loans to non-resident borrowers, subparagraph 90(9)(a)(ii) provides a deduction only for the amount of previously taxed FAPI that would have been deductible to the taxpayer under subsection 91(5).

While we understand that it was your intention that previously-taxed FAPI be deductible in respect of all upstream loans, it is not clear that a reserve would be available in respect of previously-taxed FAPI where the debtor is a Canadian resident. To the extent the adjusted cost base of the shares of a FA has been increased under section 92 in respect of FAPI, the adjusted cost base is reduced when a dividend is paid out of previously taxed FAPI. Therefore, the concern is that the paragraph 113(1)(d) deduction may not be available in those circumstances. While CRA officials recently stated at the 2013 Annual Conference of IFA, Canadian Branch, that they would be prepared to interpret the provisions as allowing a reserve in such cases, we recommend that any uncertainty be removed by amending the provisions.

Recommendation

Amend subparagraph 90(9)(a)(i) to explicitly include deductions under subsection 91(5), retroactive to the introduction of the legislation.

i. Requirement to Repay

To avoid the income inclusion or to obtain a deduction for a previous income inclusion, the loan must be repaid. With significant balances that have been used to fund other assets in the group or to pay dividends out to the shareholders, there may not be sufficient liquid assets to repay the loan. Under the current drafting of the provision, the debtor may be different than the taxpayer. As a result, the taxpayer may have limited influence over the process by which the loan is settled. For example, a Canadian Parent corporation owns all the shares in a FA and a Canadian subsidiary. The FA has lent funds to the Canadian subsidiary. If that loan is "forgiven" then the subsidiary must reduce its tax attributes or trigger an income inclusion. The "upstream loan" rule still applies to the Canadian parent even though the loan has been settled. Alternatively, the FA could distribute the loan receivable to the Canadian Parent. In neither case does the loan remain owing to a non-resident creditor, yet it appears that the upstream loan rules continue to apply because the loan was not "repaid". If the upstream loan is instead made to the direct Canadian shareholder and is subsequently forgiven, the shareholder will suffer a fully taxable income inclusion through the operation of subsections 15(1.2) and 15(1). At the same time, it does not seem that the conditions under subsection 90(8) or (14) to either exclude the income inclusion or claim a deduction are met, resulting in double taxation of the same amount.

Recommendation

Additional options should be available to settle the balance owing without triggering the duplication of an income inclusion and to facilitate the settlement of existing balances.

j. No Relief For Change in Status of Foreign Affiliate Lender or Specified Debtor

As currently drafted, the determination of whether the lender is a FA and whether the borrower is a specified debtor is made when the loan is advanced or the indebtedness is incurred. There does not seem to be any relief where the status of either entity subsequently changes. This leads to inappropriate results from a policy perspective, particularly in circumstances where the borrower is a person other than the taxpayer, because often the taxpayer may have no control over whether and when the loan will be repaid (unlike subsection 15(2), where the person with the tax exposure is always the borrower (or also the lender where the loan amount is subject to Part XIII tax), and thus presumably has at least some control over the repayment terms).

For example, assume Canco has a 20% interest in FA, which is controlled by foreign parent ("**FP**"). FA makes a loan of $100 to Forsub, which is 100% owned by FP. FA does not have any surplus, so Canco has a potential income inclusion of $20. Before the two-year period described in paragraph 90(8)(a) has expired, Canco sells its interest in FA and FP sells its interests in FA and Forsub to a 3rd party, but the loan remains outstanding. In such circumstances, it does not seem that the exception in paragraph 90(8)(a) is met (because the loan was not repaid), yet it seems the conditions in subsection 90(6) continue to be met because the status of FA as a foreign affiliate and of Forsub as a specified debtor is tested at the time the loan was made, as opposed to the end of the two-year period. Further, Canco may never be able to prove that the loan was ultimately repaid to claim a subsection 90(14) deduction. In our view, the conditions for an income inclusion should cease where either the lender ceases to be a FA of the taxpayer and/or the borrower ceases to be a specified debtor.

Recommendation

We recommend that the two-year exception in paragraph 90(8)(a) as well as the deduction in subsection 90(14) should be extended to cover not only loan repayments but also situations where either the lender ceases to be a FA of the taxpayer or the borrower ceases to be a specified debtor. This relief could be limited so as to not apply in circumstances where the debt is transferred or assumed and the transferee or new debtor is a FA or specified debtor, as the case may be, in respect of the taxpayer.

k. Issues on Reorganizations

Similar to the issue described above, there is uncertainty with respect to the application of the rules in circumstances where the debtor, the creditor, or the taxpayer under an upstream loan arrangement undergoes corporate reorganization transactions. For example, assume a FA has made an upstream loan to a debtor, and the debtor is wound up or amalgamated with another company before the loan is repaid. Similarly, the FA creditor may also be wound up or undergo a foreign merger.

As discussed above, it is not clear that the rules should continue to apply in all circumstances, particularly if the creditor has ceased to be a FA or the debtor has ceased to be a specified debtor. Assuming, however, that a particular loan or debt will remain subject to the rules despite the debtor or creditor undergoing a reorganization, what is the impact of reorganizations or changes under the transitional rules? If the loan was made before August 19, 2011 and the loan is outstanding on August 19, 2014 it will be deemed to have been made on August 20, 2014 "in the same manner and on the same terms as the particular loan or indebtedness". If the creditor or debtor no longer exists on August 19, 2014, it is unclear how the rules should be applied. It is also not clear that the relief provided by subsection 39(2.1) is available if the debtor has been party to an amalgamation or has been wound up before August 20, 2014.

Recommendation

We recommend that the rules should provide clarification with respect to their application in the context of reorganizations (including amalgamations, wind-ups, and foreign mergers).

l. Multiple Income Inclusions Where Loans Moved Within the FA Group

Subsection 90(6) applies where a specified debtor "receives [….] a loan from, or becomes […] indebted to, a creditor that is [….] a foreign affiliate." The concept of "becoming indebted to" appears to be very broad and is intended to capture debts that may not be "loans" at law. However, this broad definition in conjunction with the lack of recognition of debt settlements other than by means of repayment (discussed in point h. above) could inappropriately give rise to multiple income inclusions where the loan is transferred within a FA group either by way of assignment (new creditor) or assumption (new debtor).

For example, assume Canco owns 100% of FA1 which in turn owns 100% of FA2. Canco also owns 100% of Finco, a wholly-owned FA. FA2 made an upstream loan of $100 to Canco. FA2 then distributes the receivable to FA1 as a dividend-in-kind, and FA1 sells the receivable to Finco for cash. The loan ultimately remains outstanding for more than 2 years, and there is no surplus. In this scenario, it appears each of these transactions give rise to a separate income inclusion, as follows:

- On the initial lending by FA2, the test in 90(6) is clearly met as Canco has received a loan from FA2.
- When the loan is distributed to FA1, although Canco has not received a loan from FA1, it may have become indebted to FA1 as a result of the assignment.
- The same analysis applies when the loan is sold to Finco – Canco may have become indebted to Finco as a result of the assignment.

Similar issues arise where a new debtor assumes the loan from an existing debtor, if both are specified debtors.

Recommendation

Subsection 90(6) should be amended to clarify that no income inclusion arises where the amount giving rise to the debtor-creditor relationship is already subject to subsection 90(6). For example, this could be achieved by adding the following parenthetical exception after "or becomes at that time indebted to" *(otherwise than as a result of a transaction whereby an existing debt owed to another foreign affiliate creditor has been acquired by the current creditor or an existing debt owed by another specified debtor has been assumed by the current debtor).*

m. Paragraph 90(8)(b) Exception too Narrow

The current exception in paragraph 90(8)(b) for loans incurred in the ordinary business of a money lender is too narrow as it does not appear to contemplate situations where the creditor acquires existing loans and receivables as opposed to originating them, as is commonly the case in the financial industry (e.g., factoring of accounts receivable, mortgage and other loan securitisations, etc).

Recommendation

Paragraph 90(8)(b) should be extended to indebtedness *acquired* in the ordinary course of the creditor's business.

II. "FOREIGN TAX CREDIT GENERATOR" RULES

The October 24, 2012 Proposals include "foreign tax credit generator" rules that were originally introduced in the March 4, 2010 budget. The foreign tax credit generator rules deny, in certain circumstances, direct or indirect credits for foreign taxes where a Canadian taxpayer has a lesser direct or indirect entitlement to income or equity interest under foreign tax law in a particular entity than it has under Canadian tax law (generally, a hybrid instrument).

The October 24, 2012 Proposals reflect some welcomed modifications to the August 27, 2010 proposals. In particular, the rules are narrower in scope in that they generally require that the particular affiliate that earns the FAPI to which the FAT denial rules apply be in the same chain of ownership as the hybrid instrument, although they still do not require any connection between the hybrid instrument and the earning of FAPI.

As noted in our October 6, 2010 submission with respect to the August 27, 2010 proposals, the 2010 Federal Budget indicated that the rules were intended to address "foreign tax credit generator schemes" designed to artificially create tax credits that were being claimed by Canadian corporations as a credit or deduction in order to offset Canadian taxes. The focus of these proposals, at least from a policy perspective as indicated in the 2010 Federal Budget, appeared to be to ensure that foreign taxes that are paid and then recovered from a foreign government should not be eligible to be claimed as a credit or deduction in Canada.

The October 24, 2012 Proposals continue to have a much broader application than the apparent intent of the measure. We continue to recommend that the policy intent behind the introduction of the rules should be more clearly reflected in the rules themselves. If the rules are in fact meant to catch "schemes" that are entered into between unrelated parties and that generate "artificial" foreign tax, then they should be drafted as anti-avoidance provisions targeted at taxpayers that undertake such transactions. As currently drafted, the FTC generator rules are overreaching and will apply to many Canadian-based multinationals in non-targeted structures that were not intended to be caught.

We identify below some more specific issues in connection with the proposed rules. This list should not be considered to be exhaustive and it is likely that additional issues will arise with the application of the proposed rules to particular taxpayer situations.

a. Subsection 91(4.5) – Exception for hybrid entities

Subsection 91(4.1) denies FAT in respect of FAPI earned by a particular FA ("**FAPI affiliate**") where a "*specified owner*" of the taxpayer is considered to own less than all the shares of the capital stock of a "*pertinent person or partnership*" ("**PPOP**") under foreign tax law than under the Act.

Subsection 91(4.5) includes an exception, from the FAT denial rule in subsection 91(4.1), for hybrid entities. Subsection 91(4.5) was intended to ensure that hybrid entities are not caught by the FAT denial rule where the sole reason for the application of the FAT denial rule would be that the entities are not characterized the same way under foreign and Canadian tax law. However, the exception only appears to apply where the "specified owner" is a hybrid entity, and not where the PPOP is a hybrid entity.

For example:

- Canco owns 100% of USco1, a corporation that is tax resident in the US.
- USco 1 owns 100% of US LLC, a US limited liability company that is a disregarded entity for US tax purposes.
- US LLC owns 100% of USco2, a corporation that is tax resident in the US. USco2 earns FAPI and pays US tax on the FAPI.

US LLC is a transparent entity for US tax purposes, and a corporation for Canadian tax purposes. US LLC would be a "specified owner" in respect of Canco. US LLC would not be considered to own any of the capital stock of USco2, a pertinent person or partnership, for US tax purposes. However, US tax paid with respect to the FAPI of USco2 would not be caught by the FAT denial rules by virtue of the application of subsection 91(4.5).

However, USco1 would also be a "specified owner" with respect to Canco, and has an investment in US LLC, which is a pertinent person or partnership with respect to USco2. USco1 would be considered under US tax laws to own less shares of US LLC than it does under Canadian tax law. Therefore, subparagraph 91(4.1)(a)(i) would appear to deny USco2's FAT. Subsection 91(4.5) does not provide relief in this circumstance because it is aimed at scenarios where US LLC is the "*specified owner*".

Recommendation

We recommend that subsection 91(4.5) be amended to ensure that the exception for hybrid entities also applies to hybrid entities owned by the "*specified owner*". We suggest the following wording be added to subsection 91(4.5):

"For the purposes of subparagraph (4.1)(a)(i), a specified owner in respect of the taxpayer is not to be considered, under the relevant foreign tax law, to own less than all of the shares of the capital stock of a corporation that are considered to be owned for the purposes of this Act solely because:

(i) <u>*the specified owner is not treated as a corporation under the relevant foreign tax law*</u>***<u>; or</u>***

(ii) ***<u>the specified owner owns shares of the capital stock of a corporation that is not treated as a corporation under the relevant foreign tax law."</u>***

b. Subsection 91(4.7)

The explanatory notes to subsection 91(4.7) state that it is designed to ensure that FA shares that have *"the same substantive effect as debt in that the dividends on the shares are treated as tax deductible payments under the relevant foreign tax law are subject to new subsection 91(4.1) even where the relevant foreign tax law and Canadian tax law do not differ in their attribution of ownership of the shares or characterization of the shares".*

As drafted, subsection 91(4.7) may apply in a much broader context than its intent as detailed in the explanatory notes. Canadian-based multinationals are subject to local taxation in many jurisdictions under many different taxation systems. We recognize that the provision attempts to capture other schemes that create a deduction in the absence of differences in the tax ownership of equity interest, but in doing so, it captures ordinary features of tax regimes in certain foreign jurisdictions.

As an example, the provision may apply to rules allowing for loss relief within group of companies in certain jurisdictions. Finland, for example, has a 'group contribution system', which allows one group member to make a group contribution to another group member, which is tax deductible for the payer and taxable to the recipient.

If we consider a group contribution in light of the wording of subsection 91(4.7), a Finnish parent company would be regarded as a "specified owner" of the capital stock of a Finnish subsidiary, and "*dividends, or similar amounts*" in respect of the shares of its Finnish subsidiary are treated under the tax laws of Finland as "*another form of deductible payment*".

In this scenario, a Canadian company with Finnish subsidiaries may be denied FAT on FAPI earned by a FA in the same chain of ownership as the Finnish subsidiaries. All else being equal, it is clearly inequitable that a Canadian parent company with subsidiaries in Finland would be caught by these rules, whereas, another Canadian parent company with subsidiaries in, say, the UK would not be subject to these rules, even though the UK also has group relief provisions.

Furthermore, this group contribution system is not unique to Finland. A similar group relief system exists in Sweden and Norway, and the German Organschaft regime also has similar features that involve profit transfers as a means of tax consolidation. These regimes may raise many of the same issues that are identified above.

As there are a number of jurisdictions which provide a form of deduction for certain shares, some Canadian taxpayers could face denial of indirect credit for foreign taxes on FAs for their current taxation year in circumstances which bear no relationship to the "FTC generator schemes" originally identified by the Minister in the 2010 Federal Budget.

Recommendation

The interaction of subsection 91(4.7) with normal features of tax laws in foreign jurisdictions, such as mechanisms of group relief, may lead to the inappropriate denial of FAT. We recommend that the proposed subsection 91(4.7) be revised to accommodate group contribution regimes similar to Finland's regime.

c. Funding Through a Capital Contribution

The proposed rules apply to certain cross-chain funding arrangements between FAs, as described in proposed subsection 91(4.4). The rules may apply when, in general, as part of a series of transactions, a FA earns FAPI that is related to funding received from an affiliate in another FA ownership chain. The FAT denial rules do not apply if the funding is provided through a loan or indebtedness on arm's-length terms and conditions or "by way of the acquisition of shares of the capital stock of any corporation". This exclusion is too narrow, and does not provide relief for capital contributions made by a shareholder to a corporation owned by it. In many cases, there is no foreign tax or legal reason to issue shares for contributions made by a shareholder to a corporation. And since proposed subsection 91(4.4) was announced on October 24, 2012 but will apply to taxation years ending after that date, taxpayers may have entered into such transactions in 2012 without knowledge of the need for shares to be issued.

Recommendation

Extend the exception in subsection 91(4.4) for share acquisitions to contributions of capital made by a shareholder to a corporation.

d. Scope of Deemed PPOP Under Subsection 91(4.4)

The "funding" rule in subsection 91(4.4) has a much broader application than the "regular" definition of PPOP as it automatically brings in all the entities in the same chain of ownership as the "funding" affiliate regardless of whether or not they were involved in the "funding" transaction. For example, assume Canco owns all the shares of FA1 which in turn has two subsidiaries, FA2 and FA3. FA2 earns FAPI, while FA3 has hybrid shares outstanding which are owned by FA1. Under subsection 91(4.3), FA3 is not a PPOP in respect of FA2 because it neither has an equity percentage in FA2, nor does FA2 have an equity percentage in FA3. If FA1 makes a non-interest bearing loan to FA2 the proceeds of which are used to earn FAPI, under subsection 91(4.4), FA3 is now deemed to be a PPOP because the funding affiliate (FA1) has an equity percentage in FA3 (clause 91(4.4)(b)(ii)(A)), even though it did not contribute to the funding. Thus, the "deemed PPOP" rule is much broader than the actual definition of PPOP, which in our view is inappropriate.

Recommendations

To more appropriately target this anti-avoidance rule, we would recommend the following two changes to subsection 91(4.4):

(i) If the funding affiliate is already a PPOP under the general definition in subsection 91(4.3) [as is the case in the above example], it should be excluded from the application of subsection 91(4.4).

(ii) In other cases, deemed PPOP status should be restricted to the funding affiliate itself and should not extend to other entities in the chain. In our view, the reference in the pre-amble to "directly or indirectly provided funding" is broad enough to cause all entities that were involved in providing the funds to be subject to the deeming rule (e.g., where FA1 provided funding to FA2 which in turn provides funding to the "particular affiliate", then both FA1 and FA2 are "funding affiliates"). If you are concerned that this interpretation is not clear, then maybe a specific "reading rule" requiring subsection 91(4.4) to be applied sequentially to all entities involved in a chain of funding transactions could be included. However, we do not believe that entities that are simply in the chain of ownership but do not participate in the funding should be deemed to be PPOPs as is the case under the rules as they currently read.

e. Treatment of Disqualified Foreign Tax

As the rules are currently drafted, foreign tax that is subject to subsection 91(4.4) or 126(4.11) is not allowed as a deduction in computing the related foreign source income.[2] In contrast, tax that is excluded from underlying foreign tax by virtue of Regulation 5907(1.03) remains deductible in computing taxable earnings as the rule in Regulation 5907(1.03) applies only "for the purposes of the [….] definition "underlying foreign tax". The Federal Budget Supplementary Information dated March 4, 2010 states that "th[ese] measure[s] should generally put the Canadian corporation in the same tax position as if it had made a simple loan to the foreign corporation." In our view, it would be consistent with this policy intent to allow a deduction for the disqualified foreign tax in computing the net income from the transaction, since these transactions are structured to provide an economic return equal the net cash distributed to the taxpayer (which would not include the funds used to pay the foreign tax). Requiring an income inclusion for the amount gross of the foreign tax overstates the economic return on these transactions.

Recommendation

- Subsection 126(4.11) should apply only for purposes of section 126, such that the foreign tax could be deductible under subsection 20(12) assuming the conditions of that provision are otherwise satisfied.

- Foreign tax that is denied foreign accrual tax status under 91(4.4) should be allowable as a deduction in computing FAPI.

[2] No deduction under subsection 20(12) is available because the disqualified tax is excluded from the definition of "foreign non-business income tax".

III. OTHER LEGISLATION

a. Foreign Spin-Offs Proposed Paragraph 15(1.4)(e) and amended Paragraph 15(1)(a)

We understand that the purpose of the proposed amendments in paragraphs 15(1)(a), 15(1)(a.1) and 15(1.4)(e) was to ensure that a shareholder of an original corporation would not be in a position of receiving shares of another corporation as part of a foreign spin-off transaction that did not result in a benefit, a dividend or return of capital (*i.e.* a "nothing"). The proposed rules contemplate that spin offs should not result in a shareholder benefits if there is, amongst other things, either a reduction of capital under paragraph 53(2)(b) or a dividend under paragraph 15(1)(b). We understand that, under most foreign laws that govern foreign spin-off transactions, no amount is actually received by the shareholder from the original corporation. In order to avoid frustrating the intention of the proposed amendments, we believe that proposed subsection 90(2) must be interpreted in a manner that treats the shareholder as having received a pro rata distribution from the original corporation equal to the value of the shares of the other corporation (*i.e.*, the corporation receiving the divided property) as part of the spin-off. While CRA officials indicated at the IFA Conference that they are prepared to interpret the provisions in this manner in the context of a division of foreign affiliates, there is sufficient uncertainty that we believe that a legislative amendment would be advisable.

Recommendation

We recommend that the law be amended to specifically allow a taxpayer to elect to treat the shares of the other corporation received by the taxpayer as a pro rata distribution from the original corporation equal to the value of the shares of the other corporation received for purposes of subsection 90(2) where the original corporation is a FA of the taxpayer. Where the original corporation is not a FA of the taxpayer, the taxpayer should be able to elect to treat the shares of the other corporation received by the taxpayer as either a dividend or a return of capital under paragraph 53(2)(b).