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CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA
COMPTABLES PROFESSIONNELS AGRÉÉS CANADA

The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

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November 15, 2016

Ted Cook
Director, Tax Policy Branch
Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. Cook:

Subject: Technical Amendments Package of September 16, 2016

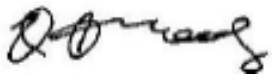
We are enclosing a submission regarding the Draft Amendments to the *Income Tax Act* (Canada) (the "Act") released on September 16, 2016. We have also included commentary regarding certain related technical amendments to the Act that we believe should be considered at this time.

A number of members of the Joint Committee and others in the tax community have participated in the discussions concerning our submission and have contributed to its preparation, including:

Dov Begun (Osler, Hoskin & Harcourt LLP)
Elizabeth Boyd (Blake Cassels & Graydon LLP)
David Bunn (Deloitte LLP)
R. Ian Crosbie (Davies Ward Phillips Vineberg LLP)
Elizabeth Johnson (PWC Law LLP)
Michael McLaren (Thorsteinssons LLP)
K.A. Siobhan Monaghan (KPMG Law LLP)
Angelo Nikolakakis (EY Law LLP)
Heather O'Hagan (KPMG LLP)
Mitchell Sherman (Goodmans LLP)
Anthony Strawson (Felesky Flynn LLP)
Jeffrey Trossman (Blake Cassels & Graydon LLP)
Sam Tyler (KPMG LLP)

We trust that you will find our comments helpful and remain interested in working with you to address the concerns of the tax community regarding the draft legislation. Accordingly, we would be pleased to discuss our submission and any questions with you at your convenience.

Yours very truly,



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- Brian Ernewein, General Director, Tax Policy Branch, Tax Legislation Division, Finance Canada
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Joint Committee of Chartered Professional Accountants of Canada and the Canadian Bar Association ("Joint Committee) to the Department of Finance (the "Department") regarding the Draft Amendments to the *Income Tax Act* (the "Act") released on September 16, 2016 (the "Draft Amendments")

The Joint Committee is pleased to make the following submission regarding the Draft Amendments.

A. Foreign Mergers – Rollover

The proposed amendments to section 87, to add new subsections (8.4) and (8.5), will permit non-resident taxpayers to elect for a tax-deferral on dispositions of taxable Canadian property ("TCP") that occur as a consequence of a foreign merger that meets certain conditions. This is a welcome amendment. However, as drafted, it applies only to shares of a taxable Canadian corporation and not to other types of taxable Canadian property that might be disposed of on a foreign merger. In our view, the scope of this amendment is too narrow in three respects as described below.

1. Shares of upper-tier foreign corporations

Under the definition of TCP, shares of a non-resident corporation may be TCP where those shares derive their value primarily from, inter alia, Canadian real estate, timber resource properties or Canadian resource properties. Consider the following example.

> ACo, a foreign public company with multiple businesses has an extensive corporate group with subsidiaries in many countries. ACo directly owns BCo, itself an operating corporation. One of BCo's assets is shares of CCo. Each of ACo, BCo and Cco is a non-resident corporation for purposes of the Act. CCo's principal asset is shares of DCo, a corporation that carries on a real estate business in Canada and, accordingly, the shares of DCo are TCP. As a result, the shares of CCo are also TCP.

Under the proposed amendments, if CCo merges with another non-resident corporation and all of the conditions of proposed paragraphs 87(8.4)(a) to (d) are satisfied, the election under proposed paragraph 87(8.4)(e) may be made and the rollover provided for in proposed subsection 87(8.5) should apply. In contrast, if BCo merges with another foreign corporation (including one in the ACo corporate group), the tax-deferral will not be available to BCo in respect of the shares of CCo. In our view, if the conditions of subsection 87(8.4) are otherwise satisfied, it would be consistent with the policy of the amendments to provide a rollover for shares that are taxable Canadian property notwithstanding that they are not shares of a Canadian corporation.

2. Partnership interests and interests in trusts

Under the definition of TCP, a partnership interest or an interest in a trust may be TCP. If a non-resident corporation (for example, CCo in the example above) owns a partnership interest or trust interest that is TCP (e.g., because of underlying Canadian real estate), and that corporation undertakes a foreign merger that would satisfy the conditions of proposed subsection 87(8.4) if the partnership interest or trust interest were a share of a Canadian corporation, it would seem reasonable that the disposition of the partnership interest or trust interest also should be eligible for a rollover.

3. Other TCP

TCP may also include assets of a non-resident corporation that are used in carrying on a business in Canada. For similar reasons, we believe a tax-deferral should be available where the non-resident corporation that carries on such a business in Canada merges with another non-resident corporation related to the first corporation and resident in the same jurisdiction as the first corporation.

Recommendation

We recommend that the tax-deferred rollover contemplated in proposed subsections 87(8.4) and (8.5) be expanded so that it applies to other classes of TCP in addition to shares of a corporation resident in Canada. As is provided in subsection 87(4), we would expect that shares acquired on the foreign merger would be deemed TCP if the shares disposed of on the foreign merger were themselves TCP.

B. Upstream Loan Rules

1. Subsection 39(2.1) and Paragraph 95(2)(g.04)

Proposed subsection 39(2.1) and paragraph 95(2)(g.04) are intended to provide relief to taxpayers that repaid upstream loans from foreign affiliates in order to comply with subsection 90(6) of the Act.

The provisions would apply to upstream loans outstanding before August 20, 2011 that were repaid, in whole or in part, on or before August 19, 2016. In general terms, the effect would be that a foreign exchange gain (loss) realized on repayment of a loan by the borrowing Canadian taxpayer would set off a foreign exchange loss (gain) realized by the lending foreign affiliate. Where the specified pre-conditions are met, the provisions would apply automatically.

While such relief is welcomed in most cases, in certain circumstances the application of these provisions would penalize a taxpayer, such that the taxpayer would prefer to opt out of their application. For example, in one case we are aware of, the borrowing Canadian taxpayer had a foreign exchange loss and the lending foreign affiliate had a corresponding foreign exchange gain. However, the lending foreign affiliate also had a separate loss from another source that could have been used to offset the foreign exchange gain. Thus, the application of proposed subsection 39(2.1) and paragraph 95(2)(g.04) in such a case would deprive the taxpayer of its foreign exchange loss and would leave the foreign affiliate's separate loss stranded.

Recommendation

We recommend that the application rules for proposed subsection 39(2.1) and paragraph 95(2)(g.04) be modified to permit the relevant Canadian taxpayer(s) to elect out of their application with respect to particular upstream loans specified in such election.

2. Ceasing to be a Foreign Affiliate

The Draft Amendments contain a number of proposed amendments to the upstream loan rules, intended to ensure that following reorganizations there is continuity for pre-existing upstream loans. These rules will assist, for example, if the debtor or creditor under an upstream loan is amalgamated with or wound up into another corporation which thereby becomes the debtor or creditor under the loan. These are welcome changes.

However, a number of other anomalies can arise under the upstream loan rules as a result of certain transactions, in part because the application of the rules depends on the relationship between the debtor and creditor at the time the loan is made. As a result, for example, if the lender under an upstream loan ceases to be a foreign affiliate, the Canadian taxpayer nonetheless continues to be subject to the rules. Consider the following example, addressed by the Canada Revenue Agency at the 2013 conference of the Canadian branch of the International Fiscal Association:

> A foreign affiliate ("Lender") of a Canadian corporation ("Canco") makes a loan to a specified debtor in respect of Canco, perhaps its non-resident parent or a non-resident sister corporation ("SD"). As a result Canco becomes subject to the upstream loan rules. A year later Canco sells the shares of Lender for fair market value proceeds (either to another corporation in the group or to an arm's length purchaser). The proceeds received by Canco for the Lender shares should reflect the loan receivable. Because Canco received fair market value proceeds for the shares of Lender that value will be fully subject to Canadian taxation. Nonetheless, because the loan is not repaid before the sale, the upstream loan rules continue to apply. As the Lender is no longer a foreign affiliate, no deduction will be available under subsection 90(9). Canco will be entitled to a deduction under subsection 90(14) but only when the loan is repaid.

The CRA's interpretation appears supported by the statutory language. Nonetheless, once the lender has ceased to be a foreign affiliate, it seems inappropriate to have an income inclusion.

Recommendation

We recommend that the Act be amended to provide that where a lender ceases to be a foreign affiliate of the Canadian taxpayer, any upstream loan made by that foreign affiliate be considered to have been repaid for purposes of subsection 90(14). We would also like to work with you to address other technical issues regarding the application of the upstream loan rules where relationships among the Canadian taxpayer, lender and specified debtor change.

C. Foreign Tax Credit Generator Rules

The Draft Amendments contain a proposed amendment to subsection 91(4.5) that is consistent with a comfort letter issued by the Department in March, 2016. This too is a welcome change. However, it appears that an analogous change should be made to each of subsection 91(4.6) and subsection 126(4.12) to address the circumstance in which a Canadian taxpayer ("Canco"), or its foreign affiliate ("FA"), is a member of a partnership ("hybrid partnership") that is treated as a corporation under foreign law, where the hybrid partnership is itself a member of a partnership ("operating partnership"). Although subsections 93.1(3) and 126(4.13) deem a partner of hybrid partnership to be a partner of operating partnership, in this fact pattern it would appear that the reference in each of paragraphs 91(4.6)(b) and 126(4.12)(b) to "the partnership" refers to the operating partnership, which is not the partnership that is treated as a corporation under foreign law, as required by those provisions. Accordingly, and to be consistent with the changes to subsection 91(4.5), we believe that the exceptions in paragraphs 91(4.6)(b) and 126(4.12)(b) should be revised to encompass any partnership in the direct ownership chain (rather than just the operating partnership) that is treated as a corporation under the relevant foreign tax law.

Recommendation

We recommend that the reference to "the partnership" in each of paragraphs 91(4.6)(b) and 126(4.12)(b) be revised to include any partnership in the direct ownership chain.

D. Stub Period FAPI Rules

The proposed stub period FAPI rules in subsections 91(1.1) to (1.5) are a noted improvement on the initial proposals that were released on July 12, 2013, including revisions to address several of the recommendations from our September 30, 2013 submission. We acknowledge and thank you for the amendments. However, that said, having reviewed the latest proposals and considered the practical implications that could arise from them, we believe the stub period FAPI rules should be further refined to address certain inappropriate outcomes that continue to exist.

1. Triggering Event

As currently drafted, subsection 91(1.2) would apply at any time there is an acquisition or disposition of shares of a foreign affiliate ("FA") of a taxpayer that results in a change to the surplus entitlement percentage ("SEP") of the taxpayer in respect of the FA, provided an amount would be included in the taxpayer's income under subsection 91(1) if the taxation year of the FA had ended immediately before the acquisition or disposition. The addition of a "transactional" triggering event is an important one, as it addresses the concern of a deemed year end arising where an FA has more than one class of shares outstanding and the SEP of those shares varies over time as a function of the FA's earnings or other factors. However, given that FAPI is allocated based on participating percentage ("PP") rather than SEP, and that PP and SEP may not correspond when an FA has more than one class of shares, we believe that basing the triggering event on SEP rather than PP could lead to inappropriate consequences. Consider the following example:

> Canco owns all of the common shares of an FA with a December 31 year end. NRco, who deals at arm's length with Canco, owns preferred shares of FA. The preferred shares are entitled to a preferred dividend of $100,000 per year which becomes payable (and is paid) on December 31 of each year. FA has historical net surplus of $200,000. FA earns $100,000 of FAPI in 2017, which accrues evenly throughout the year, and has no other earnings for the year. On June 30, 2017, Canco sells 10% of the common shares of FA to NRco.
>
> In this example, absent the stub period FAPI rules, there would be no FAPI attributed to the common shares since the PP of the common shares would be nil on December 31, 2017. On this basis, the sale of 10% of the common shares to NRco has no impact on the amount of FAPI that would otherwise accrue to Canco. However, under the proposals, Canco would have a FAPI inclusion of $50,000 for the June 30, 2017 stub period. This is because Canco's SEP would be 100% immediately prior to the sale and 90% immediately following the sale, resulting in a stub period end time of June 30, 2017, and the common shares would have a PP of 100% at that time since there were no dividends paid or payable on the preferred shares at that time. Having a FAPI inclusion for Canco in these circumstances is an inappropriate outcome.

Further, it appears that testing based on whether the acquisition or disposition results in a decrease in SEP (or PP) at the time of the acquisition or disposition can lead to anomalous results, as the decrease in SEP (or PP) can often occur at a later date. For instance, assume Canco owns all of the common shares of an FA that earns FAPI. NRco, who deals at arm's length with Canco, subscribes for preferred shares of

FA on October 1, 2017. The preferred shares have a quarterly dividend that becomes payable on March 31, June 30, September 30 and December 31. As currently drafted, the proposed stub period FAPI rules would not apply since the acquisition of the preferred shares does not result in a change to SEP (or PP). Rather, the change arises when dividends become payable on the preferred shares on December 31, 2017. Presumably the stub period FAPI rules are intended to apply in this scenario.

Recommendation

We recommend that the triggering event for the stub period FAPI rules be an acquisition or disposition of shares of the particular FA that can reasonably be considered to have resulted in a decrease in the PP of a share of an FA owned by the taxpayer, as determined at the normal year end of the FA. This approach would ensure that a stub period end time arises when – and only when – the acquisition or disposition has an impact on the amount of FAPI that would otherwise be allocated to the taxpayer at year end. We believe this is consistent with the policy intent of the proposed FAPI stub period rules.

If this recommendation is not adopted and the triggering event remains as currently drafted, we believe an exception should be added for situations where it is reasonable to conclude that the acquisition or disposition had no impact on the amount of FAPI that would otherwise have been allocated to the taxpayer at the normal year end of the FA.

2. De Minimis Exception

The inclusion of a *de minimis* exception is a welcome addition to the stub period FAPI rules. However, we believe there continue to be situations where numerous deemed year ends can arise in inappropriate circumstances.

As currently drafted, if there are a large number of acquisitions and dispositions during the year that result in a net decrease to SEP of more than 5%, each acquisition and disposition will result in deemed year end, regardless of the significance of each discrete acquisition or disposition. Assume, for instance, that Canco owns 90% of the common shares of an FA that has an employee stock option plan. The employee stock option plan results in shares being acquired and disposed of on a regular basis, but each acquisition and disposition has a modest impact on SEP (and PP). If Canco sells 10% of the shares of the FA during the year, resulting in a net decrease in SEP (and PP) for the year of more than 5%, every acquisition and disposition during the year would give rise to a stub period end time, resulting in significant compliance issues.

Recommendation

We recommend that the *de minimis* exception apply to all dispositions and acquisitions that result in a change in SEP (or PP if our earlier recommendation is adopted) of less than 5% unless the acquisition or disposition is part of a series of acquisitions and dispositions, one of the main purposes of which is to avoid FAPI.

Alternatively, if the *de minimis* exception were to remain as currently drafted, we recommend that there be an additional *de minimis* exception for each discrete acquisition or disposition that results in a change to SEP (or PP) of less than 1%.

3. Use of Elections

The elections in subsections 91(1.4) and (1.5) allow taxpayers to opt into the stub period FAPI rules in certain circumstances.

In an arm's length scenario, such as the one illustrated as Example #2 in the Explanatory Notes, the election in subsection 91(1.5) allows the arm's length purchaser of the FA shares to elect to have a stub period year end similar to the vendor of the shares, which is beneficial in circumstances where the carve-out rule in paragraph 95(2)(f.1) does not apply.

Subsection 91(1.4) allows a taxpayer to avoid the duplication of FAPI attribution in certain circumstances, including the situation where a higher-tier FA sells shares of a lower-tier FAPI-earning FA (Example #1 in the Explanatory Notes). The duplication is eliminated where Canco elects to have subsection 91(1.2) apply.

From a policy perspective, it seems unfair that, without making an election, the same income would be subject to tax twice. Further, given the measures are intended to be relieving, it would seem more appropriate from a tax policy perspective to have the rules apply automatically and provide taxpayers with the ability to file an election to "opt out" of the rules.

Recommendation

We recommend that the rules in subsections 91(1.4) and (1.5) apply by default, with taxpayers being granted the option to make an election to have the rules not apply.

4. Excluded Property Share Carve-Out in Subsection 91(1.4)

Paragraph 91(1.4)(b) requires that, immediately after the particular time, there is a disposition of shares of the particular FA. This disposition has to be by the taxpayer or a controlled foreign affiliate ("CFA") of the taxpayer. If the disposition is by a CFA of the taxpayer, the provision stipulates that the shares cannot be excluded property immediately after the particular time. In situations where the shares of the particular FA are sold, it would not be possible to apply this test, since the shares would cease to be shares of an FA at the particular time. Further, it is not clear why the excluded property status of the shares should be a requirement. While a sale of excluded property shares by a CFA does not give rise to FAPI, it results in hybrid surplus. Consider, for instance, a scenario with facts similar to those in Example #1 of the Explanatory Notes, but where the shares of FA2 qualify as excluded property of FA1. In that case, FA1 would recognize hybrid surplus from its sale of the shares of FA2 to FA3. When Canco subsequently sells the shares of FA1 to an arm's length party, Canco would realize a capital gain. The value of the shares of FA1 would include the value of the consideration received by FA1 on the sale of the shares of FA2 to FA3, which would include the value of any income that had accrued in FA1 to the time of sale. In addition, all of FA2's FAPI would be included in computing Canco's income for its taxation year that includes FA2's taxation year end. This effectively results in double taxation since the portion of the FAPI of FA2 that accrued in the first half of the year would contribute to a larger capital gain for Canco on the sale of the shares of FA1 and would also be taxable to Canco as FAPI.

Recommendation

We recommend that paragraph 91(1.4)(b) refer to dispositions by the taxpayer or a CFA of the taxpayer, irrespective of whether the shares of the particular FA are excluded property. If an excluded property

requirement is to be included, the relevant time for testing excluded property status should be at the particular time, rather than immediately after the particular time.

5. Exception for Corresponding Increase in SEP

Proposed subparagraph 91(1.1)(b)(i) includes an exception for situations where the acquisition or disposition that results in a decrease in SEP for the taxpayer leads to a corresponding increase in SEP for one or more taxpayers, each of which is a taxable Canadian corporation that does not deal at arm's length with the taxpayer. The exception does not apply where the taxpayer with the increase in SEP is a non-arm's length Canadian individual or trust. Thus, double tax can arise, for instance, if shares of a FAPI-earning CFA are transferred by a Canadian corporation to a Canadian individual who controls the Canadian corporation.

Recommendation

We recommend that the exception in subparagraph 91(1.1)(b)(i) be extended to situations where the taxpayer is a non-arm's length Canadian individual or trust who would, if it were a Canadian corporation, have the corresponding increase in SEP.

6. Election in Subsection 91(1.5)

Proposed subsection 91(1.5) allows an arm's length purchaser of FA shares to elect to have a stub period year end similar to the vendor of the shares. The election is not available when FA shares are purchased from a non-resident. In certain cases, FAPI accruing prior to the acquisition will be carved-out under existing paragraph 95(2)(f.1), but this is not universally the case. We believe some seemingly arbitrary results can arise under a combination of proposed subsection 91(1.5) and existing paragraph 95(2)(f.1)

Assume, for instance, that Canco owns 10% of the shares of an FA and then buys the other 90% from a non-resident person shortly before the last day of FA's taxation year. Canco will be required to include 100% of the FAPI for the year in its income because the carve-out rule in existing paragraph 95(2)(f.1) does not apply and the election in proposed subsection 91(1.5) is not available. However, if Canco owned 9.9% of the shares of FA prior to the acquisition, the carve-out rule in paragraph 95(2)(f.1) would apply and the result would be entirely different. Similarly, the result would be different if Canco purchased the remaining 90% from a Canadian resident rather than a non-resident, because the election in proposed subsection 91(1.5) would be available in that case.

Recommendation

We recommend that the election in subsection 91(1.5) be extended to situations where shares of an FA are acquired from a non-resident person.

E. Foreign Affiliate Dumping ("FAD") Rules

The Draft Amendments contain some proposed amendments to the FAD rules which primarily expand the scope of the rules to investments in non-resident corporations that are not foreign affiliates of the corporation resident in Canada ("CRIC") that makes the investment but are foreign affiliates of a non-arm's length person. We have a number of concerns with the proposed scope of the amendments. In that connection, we sent the Department a number of examples as an informal submission and have

determined not to repeat those concerns here. However, we have enclosed a copy of those examples and would welcome the opportunity to discuss them with you at your convenience.

In addition to the issues raised by the proposed amendments, we thought it appropriate to raise a number of other technical issues we have identified with the FAD rules. These are described below.

1. Paragraph 212.3(7)(d)

Where the amount of a deemed dividend otherwise arising under paragraph 212.3(2)(*a*) is reduced because of any of subparagraphs 212.3(7)(*a*)(i), (*b*)(i) and (*c*)(i), paragraph 212.3(7)(*d*) requires a CRIC to file a form containing prescribed information (the "Form"). The Form must be filed by the CRIC on or before its filing-due date for its taxation year that includes the dividend time, and must contain (in addition to prescribed information) the following:

- the amount of the paid-up capital ("PUC"), determined immediately after the dividend time and without reference to subsection 212.3(7), of each class of shares that is described in paragraph 212.3(7)(*a*) or that is a cross-border class in respect of the investment;
- the PUC of the shares of each of those classes that are owned by the parent or another non-resident corporation that does not, at the dividend time, deal at arm's length with the parent; and
- the reduction of PUC under subparagraph 212.3(7)(*a*)(ii), (*b*)(ii) or (*c*)(ii), as the case may be, in respect of each class.

If the Form is not filed on time, subparagraph 212.3(7)(*d*)(ii) deems the CRIC to have paid, and the parent to have received, a dividend (a "Late-Filing Dividend") equal to the total of the dividend reductions under any of subparagraphs 212.3(7)(*a*)(i), (*b*)(i) and (*c*)(i). Interest applies to the unpaid withholding tax on the Late-Filing Dividend.[1] Subsection 227(6.2) (as discussed below) will provide, in some circumstances, for a refund of Part XIII tax paid in respect of the Late-Filing Dividend.

We would like to thank you for considering the concerns we previously raised regarding this filing obligation, and for extending the filing date for the Form and relieving the automatic penalty for failure to withhold. However, we believe that these changes do not go far enough in addressing our fundamental concern. In our view, the consequences which this provision imposes are not appropriate, and may in many circumstances create a result that is overly harsh.

As the FAD rules were being formulated, we repeatedly expressed the view that many of the provisions were too expansive in relation to the mischief at which the rules are aimed. Many transactions that have nothing to do with debt dumping or surplus stripping may be subject to the rules. As part of these discussions, the automatic PUC offset was viewed as an important safeguard against the application of the rules in unwarranted situations. Those CRICs with "excess" PUC (i.e. PUC that is not currently needed to support distributions or thin capitalization room) could take comfort that the "innocent" application of the FAD rules to an investment made by the CRIC would not give rise to a deemed dividend, and consequent withholding tax. The automatic nature of this relief was especially important to many

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[1] Paragraph 227(8.5)(*b*) provides that penalties under subsection 227(8) do not apply in respect of a failure to pay Part XIII tax on the deemed dividend under subparagraph 212.3(7)(*d*)(ii).

taxpayers, particularly given the CRA's policy to administer these rules broadly (see, for example, the responses to the FAD questions at the 2014 Canadian IFA roundtable).

Against this background and context, we believe that it is inappropriate to require the CRIC to file the Form in order to prevent a Late-Filing Dividend from arising.

PUC Has Been Reduced

Where applicable, subsection 212.3(7) automatically offsets the paragraph 212.3(2)(*a*) dividend with available PUC. In other words, the dividend otherwise arising under paragraph 212.3(2)(a) is reduced or eliminated, and the PUC of the shares of the CRIC (or a qualifying subject corporation ("QSC")) is automatically reduced. Accordingly, the intended consequence of the CRIC's investment has occurred at the time, and in the manner, specifically contemplated by the Act. Nothing further is required to achieve this result. We believe that it is both inappropriate and inconsistent with the intent of the rules to provide that subsection 212.3(7) applies automatically, and yet require a filing to ostensibly avoid dividend treatment under the FAD rules. Furthermore, because this penalty applies only to a CRIC group that has sufficient PUC available for offset, the rules actually punish such a CRIC group (in comparison to a CRIC group without sufficient PUC) because the FAD rules effectively impose two consequences for one transaction: both a PUC reduction and a deemed dividend.

In our view, deeming a Late-Filing Dividend to have been paid by the CRIC to the parent unnecessarily confuses a liability for tax resulting from a reporting failure with an actual liability for tax. In this sense, the deemed dividend (and any interest in respect thereof) is akin to a form of "double taxation" penalty. To make matters worse, it appears that the Late-Filing Dividend is not eligible for election under subsection 212.3(3), so that the withholding tax rate for the reporting failure may be higher than the rate that could have applied to a substantive dividend under paragraph 212.3(2)(a). Again, the consequence for simply not reporting may be worse than actual tax liability that would have arisen in the absence of a PUC offset.

Moreover, we note that this requirement for positive action to eliminate a tax imposed on the parent (as a result of the Late-Filing Dividend) may have securities laws implications for a CRIC that is a public company controlled by the parent. We understand that this was one of the reasons the offset was made "automatic".

Collateral Issues

It seems to us that the overall policy intent of this provision is to provide for a monetary consequence in respect of a failure to report a PUC offset arising from a CRIC investment, not to provide for a second substantive tax effect (i.e. both a withholding tax liability and a reduction of PUC). Moreover, because a refund may be sought within two years of filing the Form (without, apparently, imposing any specific time limit on when the Form may be filed), it seems that the Department does not really intend that a second tax liability would actually arise, but rather only that interest would run on the withholding tax balance until the Form is filed. In our view, such a mechanism is inappropriate and awkward, is significantly harsher than other penalties in the Act related to late filing of forms, and may result in unintended consequences.

(a) Parent Liability

The obligation to report an investment will normally rest with the CRIC. However, by creating a deemed dividend to the parent, it appears the parent also could be liable for the withholding tax. In normal

situations, applying the primary liability for Canadian withholding tax to a non-resident recipient of a dividend makes sense (the recipient has received money or money's worth). In this context, however, the parent has received no such value, and has already suffered the appropriate PUC reduction consequence. As a general policy matter, there should be no reasonable basis to attach liability to a shareholder for the CRIC's failure to file the Form. Although the obligation to fund withholding tax for the dividend (but not the interest) may be removed by filing for a refund, one could imagine anomalous situations where the reporting and dividend obligation come to light following a sale of the CRIC by the parent. In this regard, the obligation to file for a refund – to achieve the very result which the Department seems to intend – has the prospect of being a "trap for the unwary", or a trap for a parent that may no longer control the CRIC.

(b) Director Liability

Further, by deeming a dividend to have arisen due to the CRIC's failure to file the Form, it appears that the directors of the CRIC could be personally liable for the Part XIII tax in respect of such dividend. This seems manifestly unfair in a context where no funds have actually left Canada without withholding, and the appropriate tax consequence (PUC reduction) has already arisen by virtue of the transaction.

(c) Accruing Interest

Interest accrues on the withholding tax payable in respect of the Late-Filing Dividend until the refund is sought and obtained. In our view, this "penalty" for failure to file is unwarranted. In most cases under the Act, interest runs in favour of the Government because funds, which are owed to the Government, have been retained by the taxpayer. In that context, interest serves its normal function in commerce – it compensates someone for the use of their money. In the present situation, because no tax liability requiring a payment arises from an automatic PUC reduction, it makes no sense to accrue an interest charge on this purely hypothetical amount.

Recommendation

We fully acknowledge the need for CRA to be able to effectively audit FAD transactions. However, we do not believe that this is a special circumstance, certainly not one that warrants the potential for an oppressive penalty in relation to a failure to report. As a general matter, there is no obligation in the Act to maintain and report PUC balances in shares. However, there are many existing reporting provisions in the Act which the Department could use as a model for formulating this reporting obligation and the consequence of any failure.

In general, however, we recommend that the Act be amended as follows:

(i) the penalty for failure to report a PUC reduction should rest solely with the CRIC, and neither the parent nor the CRIC's directors should be liable therefor;

(ii) the basic penalty should be reasonably limited in quantum (similar to, for example, the basic penalty for failure to file a T1134); and

(iii) if the Department believes that a more significant penalty is also needed in certain circumstances (including a penalty where the quantum has some direct or indirect reference to the amount of the PUC reduction), such additional penalty should be restricted to situations involving gross negligence or wilful failure to file following a demand for information by CRA.

2. FAD and Partnerships

Subparagraph 212.3(18)(b)(viii) was recently enacted to add an additional category of reorganization exception from the application of the FAD rules, i.e. for an investment by a CRIC in shares of a foreign affiliate as a result of a disposition of the foreign affiliate shares by the CRIC to a partnership pursuant to a transaction to which subsection 97(2) applies. While this addition to the paragraph 212.3(18)(b) reorganization exception may have been intended to provide some clarity (and we welcome the Department's receptiveness to ensuring that the rules work as was intended), we believe that, in light of the partnership "look-through" rules in subsection 212.3(25), the addition of subparagraph 212.3(18)(b)(viii) creates uncertainty and, in any event, is too limited in its scope, as there may be scenarios in which either it is not possible to make a subsection 97(2) election, or such an election would not normally be made (i.e., where there is an accrued loss). Moreover, this exception does not address any change in the indirect interest of the transferor in other properties of the partnership that may be consequential on the rollover (or the indirect interest of other members of the partnership in the transferred foreign affiliate shares).

We believe that the transfer of shares to a partnership should be capable of being analyzed under the look-through rules in subsection 212.3(25) and that, if any clarifying rule is necessary, it is best dealt with through minor modifications to that subsection. Consider the following example:

> Assume that: (a) USCo owns (and always has owned) all of the shares of Canco1, Canco2 and Canco3; (b) Canco1 holds all of the shares of a FA1; (c) Canco2 and Canco3 are members of a Canadian partnership which holds all of the shares of FA2; and (d) Canco1 transfers the FA1 shares to the partnership in consideration for partnership units. Depending on the circumstances (i.e., whether there is an accrued gain on the FA1 shares), a subsection 97(2) election may or may not be made.

Pursuant to subparagraph 212.3(25)(c)(i), Canco1 will be deemed to acquire an interest in the FA2 shares that are held by the partnership prior to the transfer by Canco1 of the FA1 shares to the partnership. This acquisition will be considered a paragraph 212.3(10)(a) investment because of the look-through rule in paragraph 212.3(25)(b). This acquisition does not appear to be addressed by subparagraph 212.3(18)(b)(viii) because the FA2 shares are not the foreign affiliate shares that were transferred by Canco1 to the partnership. Moreover, paragraph 212.3(18)(a) may not apply because the deeming rule in subparagraph 212.3(25)(c)(i) does not address *from whom* the property is (deemed to be) acquired, although it would appear that, given subsection 212.3(25), the FA2 shares should be considered to have been acquired from the other partners (i.e., Canco2 and Canco3).

However, we believe that the effect of the partnership look-through rules in subsection 212.3(25) should be that:

- To the extent that Canco 1 would otherwise be considered to have acquired an interest in the FA1 shares, it should not, because its indirect interest in a portion of those shares is imputed to it under paragraph 212.3(25)(b). In other words, before the transfer it owned the shares directly and after the transfer it will be considered to own a portion of the shares.
- To the extent that Canco 1 is considered to have acquired an interest in the FA2 shares, the interests of Canco2 and Canco3 in those shares should have decreased accordingly, and that should be a related party transaction that is within the reorganization exception in paragraph

212.3(18)(a). Paragraph 212.3(25) supports this conclusion because it deems any transaction participated in by the partnership to have been participated in by the members of the partnership.

- A similar analysis should apply to the interest in the FA1 shares that Canco2 and Canco3 are deemed to acquire.

The partnership rollover reorganization exception does not address the position of Canco2 or Canco 3 (in the fact pattern above) and is limited in its application to the position of Canco 1.

We suggest that subparagraph 212.3(18)(b)(viii) be amended to extend its application beyond transfers to which subsection 97(2) applies. In addition, to the extent that the deeming rules in subsection 212.3(25), as a technical matter do not squarely address the question of *from whom* the property is (deemed to be) acquired for the purposes of the reorganization exception in paragraph 212.3(18)(a), we suggest that a clarifying "for greater certainty" rule be considered (with retroactive effect). Please see the recommendations below.

Recommendation

We recommend that:

(a) the requirement in subparagraph 212.3(18)(b)(viii) that subsection 97(2) apply to the transfer of the shares to the partnership be removed such that it applies any time that shares of a foreign affiliate are transferred by a CRIC to a partnership for consideration that includes an interest in the partnership;

(b) subparagraph 212.3(25)(c)(i) be amended, with effect from the date it became effective, to read: "to acquire from each member of the partnership that was a member of the partnership immediately before that time that proportion of the additional portion of the property that is equal to the decrease in the portion of the property that is deemed under paragraph (b) to be owned by that member of the partnership."; and

(c) examples be included in the Explanatory Notes explaining the operation of subsection 212.3(25) in circumstances in which a CRIC becomes or ceases to be a member of a partnership and in circumstances in which shares of a foreign affiliate are acquired by or at that time owned by a partnership.

3. PUC Reinstatement and Preferred Shares

We observe that the formulas for PUC reinstatement in paragraph 212.3(9)(b) do not work appropriately in all circumstances.

Consider the following examples:

a) CRIC, controlled by a non-resident corporation, issues preferred shares to provide CRIC with sufficient cash to acquire shares of a foreign target ("FT"). The holder of the preferred shares pays $1,000,000 for the preferred shares and CRIC uses that amount to acquire the FT shares, an investment described in paragraph 212.3(10)(a). Accordingly, pursuant to subsection 212.3(7), the PUC of the CRIC preferred shares will be reduced by $1,000,000 to nil. Assume that, several months after the acquisition of FT, FT sells some redundant assets and pays a dividend of $100,000

to CRIC. CRIC in turn would like to (or may be obligated to) redeem 10% of the preferred shares. Under subparagraph 212.3(9)(b)(ii), $100,000 of PUC will be reinstated to the preferred shares immediately before CRIC redeems the preferred shares. However, because the PUC will be averaged over all of the preferred shares, if CRIC redeems the preferred shares, a deemed dividend of $90,000 will arise. If two years later CRIC sells the FT shares and uses $900,000 to redeem the remaining preferred shares, the PUC that will be reinstated is $900,000. Because the remaining preferred shares will already have PUC of $90,000 from the earlier redemption, the total PUC of the shares will be $990,000 but the redemption price for the preferred shares will be limited to $900,000. The $90,000 "extra" PUC on the remaining preferred shares is a reflection of the PUC reinstatement "deficiency" at the time the first redemption occurred. As all shares of the class will have been redeemed, that extra PUC will be lost. Moreover, the holder of the preferred shares should not have been deemed to have received a dividend at the time of the first redemption.

b) We have also observed other circumstances in which the formula in the description of B in subparagraph 212.3(9)(b)(i) can operate to "under-reinstate" PUC and even to "over-reinstate" PUC. For example, where there are two QSCs with disproportionate interests in the CRIC and the PUC of the QSCs has been reduced on a proportionate basis as a consequence of the application of subparagraph 212.3(7)(c)(iii), a disproportionate reinstatement will arise on a subsequent distribution by either of the QSCs. That reinstatement will either fall short of or exceed the appropriate portion of the PUC of the QSC that was reduced and that should be reinstated by virtue of the distribution. This occurs because the formula in subparagraph 212.3(9)(b)(i) allocates the reinstatement among the QSCs as a function of their respective equity percentages in the CRIC, whereas subparagraph 212.3(7)(c)(iii) allocates the initial PUC reduction on a different basis, being the relative PUC of the shares of the QSCs.

Recommendation

We recommend that the formulas in subsection 212.3(9) be amended to avoid the anomalies that may arise when there a partial reinstatement of PUC.

4. Emigration

Subsection 219.1(3) sets out the conditions for the application of subsection 219.1(4). This latter rule provides a PUC reinstatement where a CRIC that previously had its PUC reduced under paragraph 212.3(2)(b) or (7) emigrates from Canada.

As the Joint Committee described in our October 15, 2013 submission (regarding the August 16, 2013 proposed amendments), we are concerned that these conditions are overly restrictive. In particular, the condition in paragraph 219.1(3)(c) requires that "subsection 212.3(9) has not applied in respect of any reduction of the paid-up capital in respect of a class of shares of the capital stock of the corporation or a specified predecessor corporation (as defined in subsection 95(1)) of the corporation)". This condition is too restrictive because any amount of previous reinstatement under subsection 212.3(9) — as little as a $1 — would preclude a reinstatement under subsection 219.1(4). This seems particularly harsh.

Accordingly, we believe that this result is both inappropriate and inconsistent with subsection 212.3(9), which reduces subsequent reinstatements of PUC only by the amount of PUC previously reinstated. In this manner duplicative reinstatements are prevented.

Recommendation

We recommend that subsection 219.1(3) be amended in a manner consistent with the principles of subsection 212.3(9) so that the limitation under section 219.3 takes into account only amounts previously reinstated under subsection 212.3(9).

F. Derivative Forward Agreement

In our 2013 submission to the Department with respect to the derivative forward agreement rules, we observed that a typical currency forward transaction involves the purchase of one currency and the sale of another currency and may be used to hedge a taxpayer's exposure to the value of any given currency in connection with a particular capital property *or liability on capital account*. We would like to thank you for and acknowledge the proposed amendment to the definition of derivative forward agreement which largely addresses our concern. However, the proposed amendment appears to have a small error. Proposed subparagraphs (b)(iii) and (c)(ii) refer to "the value of the currency in which a purchase or sale by the taxpayer of a capital property is denominated, in which an obligation that is capital property of the taxpayer is denominated or from which a capital property of the taxpayer derives its value." Consistent with our submission in 2013, we believe the reference to obligation is intended to address an obligation of the taxpayer (e.g., indebtedness of the taxpayer) since an obligation of some other person held by the taxpayer is presumably included within the description "currency…from which a capital property of the taxpayer derives its value". Assuming that is correct, we believe the language should be modified to reflect that an obligation of a taxpayer is not property.

Recommendation

We recommend the phrase "an obligation that is capital property of the taxpayer" in each of proposed subparagraphs (b)((iii) and (c)(ii) of the definition of derivative forward agreement be amended so that it reads "an obligation that is incurred on capital account by the taxpayer" or "an obligation of the taxpayer in respect of which subsection 39(2) would apply if the taxpayer made a gain or loss because of a fluctuation in the value of a currency other than a Canadian currency".

G. Regulation 6204 – Prescribed Shares

The draft amendments include a proposal to amend paragraph 6204(1)(b) of the Regulations to add new subparagraph (iv). We acknowledge the intended relieving nature of this proposed change, but are concerned about the potential implications of the proposed amendment to paragraph (b) on interpretative issues under paragraph (a).

For example, subparagraph 6204(1)(a)(iii) provides that a share will not be a prescribed share if it is convertible into any other security, other than into another security of the corporation *or of another corporation with which it does not deal at arm's length* that is, or would be at the date of conversion, a prescribed share.

Under current paragraph 6204(1)(b), a share will not be a prescribed share if it is reasonable to consider that the corporation or a specified person can reasonably be expected to acquire the share within two years of it being issued. Read literally, this second restriction could be seen as overriding the exceptions in paragraph 6204(1)(a). For example, if the employee stock option is one to acquire a voting common share of subsidiary which is convertible into .5 voting common shares of another non-arm's length parent corporation, that would satisfy the test under subparagraph (1)(a)(iii). It seemed implicit that, where one

of the specific exceptions in paragraph 6204(1)(a) was available, the more general provisions of paragraph 6204(1)(b) would not apply; this interpretation appears to be consistent with the purpose of the rules in Section 6204. More particularly, it would appear to be a perverse interpretation to say that it is acceptable to have a right to convert into prescribed shares but that if that right is expected to be exercised within two years of exercising the option the share would not qualify as a prescribed share. However, the lack of express language regarding the interaction of the permitted conversion right in subparagraph 6204(1)(a)(iii) and the more general prohibition in paragraph 6204(1)(b) creates some uncertainty regarding this interpretation. We understand this uncertainty led to the request for changes to paragraph 6204(1)(b).

The proposed change to paragraph 6204(1)(b) contained in the Draft Amendments would appear to provide greater certainty in circumstances in which it applies, but also appears to make a similar (but equally appropriate) result less certain in conversions for prescribed shares that are described in paragraph 6204(1)(a) but which do not come within the ambit of the revised paragraph 6204(1)(b). The amendment seems to imply that the "convertible" voting share in the example above would not be a prescribed share if it was reasonable to expect the conversion right to be exercised within the two-year period. Given the exceptions in paragraph 6204(1)(a) for conversions to shares of another corporation, it would seem appropriate to extend the proposed amendment to paragraph 6204(1)(b) to any transaction by which shares are acquired, including on a taxable basis or on a tax-deferred basis under section 85.1 or subsection 85(1), provided that the only consideration received on the exchange is prescribed shares.

Separately, as outlined in a Joint Committee submission made in 2005, we believe that there are a number of significant technical issues concerning the prescribed share rules that should be addressed. These issues can make the preservation of prescribed share status difficult or impossible in a range of commonly occurring transactions and circumstances where, in our view, the preservation of prescribed share status would not present policy concerns. Accordingly, we believe that it may be an appropriate time to review the prescribed share rules in more detail to address a number of issues, including those raised in the 2005 Joint Committee submission. However, regardless of any other changes that might be made, we believe that the "safe harbours" in paragraph 6204(1)(a) should apply also under paragraph 6204(1)(b).

Recommendation

We recommend that subsection 6204(1) be amended to explicitly provide that any exception or "safe harbour" under paragraph 6204(1)(a) is also an exception or "safe harbour" for purposes of paragraph 6204(1)(b). Moreover, we suggest that a broader review of the prescribed share rules should be considered to address technical anomalies that arise in applying them to common transactions. We would be pleased to provide specific examples of these anomalies.

FAD Amendments

Questions and Interpretation Issues

- Conceptually, why is "other Canadian corporation" ("**OCC**") concept added to (b) as well as to (a)? Is it necessary to satisfy the objectives of the amendments?

- Explanatory Notes suggest that OCC must be a corporation resident in Canada but legislation is less clear.

- Is OCC in (b) meant to refer to every NAL corporation, or only to a NAL corporation of which the subject corporation is a FA?

- Should para 251(5)(b) rights be excluded?

- Changing the amendments to contemplate the issues in the second, third and fourth bullets above would address many of the problems in the attached slides but not those in examples 4A and 4B.

Recommendations

- The legislation should be clarified to confirm that OCC must be a corporation resident in Canada.

- The "non-arm's length" condition should be replaced with a "related" condition, and the determination should be made without regard to para 251(5)(b).

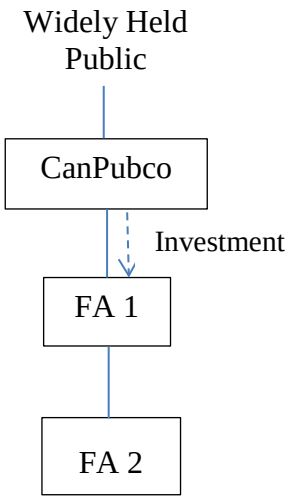
- The addition of OCC to (b) of the amendments should be deleted.

- As an alternative to the foregoing, both (a) and (b) should remain as they currently exist and, instead of the proposed amendments, a cross-deeming rule should be added as follows:

  "For the purposes of this section, if at any time a non-resident corporation is a foreign affiliate of a particular corporation resident in Canada, the non-resident corporation shall at that time be deemed to be a foreign affiliate of every corporation resident in Canada that is at that time related to the particular corporation (otherwise than because of a right referred to in paragraph 251(5)(b))."

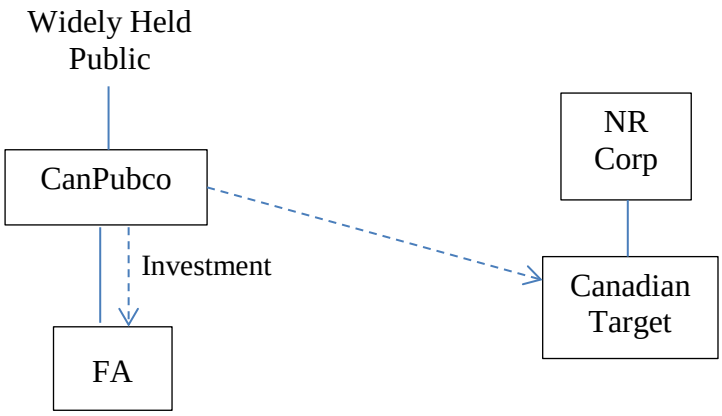
FAD Amendment Examples

Example 1 (technical issue)



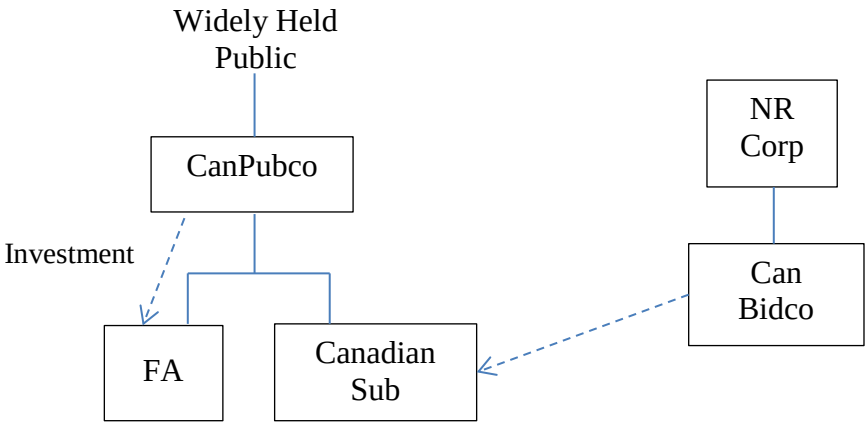
- The FAD rules will apply to the investment by CanPubco into FA 1 because CanPubco is NAL with FA 2, which is a corporation controlled by a non-resident corporation.
- Para 212.3(15)(a) does not apply to alter control of FA 2.
- Changing definition of OCC to refer only to a corporation resident in Canada would correct this example.
- However, this correction, in itself, would not be sufficient if FA 1 or FA 2 happened to have a Canadian resident subsidiary (however, para 212.3(15)(a) might apply to the lower tier Canadian resident subsidiary).

Example 2A (para 251(5)(b))



- Assume CanPubco has an agreement to acquire all of the shares of Canadian Target from NR Corp, or to acquire the shares of NR Corp.
- The FAD rules will apply to CanPubco's investment in FA because CanPubco is related to and therefore NAL with Canadian Target, which is controlled by a non-resident corporation.
- The FAD rules would not apply if the investment in FA was made after the acquisition was completed. Accordingly, para 251(5)(b) rights should be excluded.

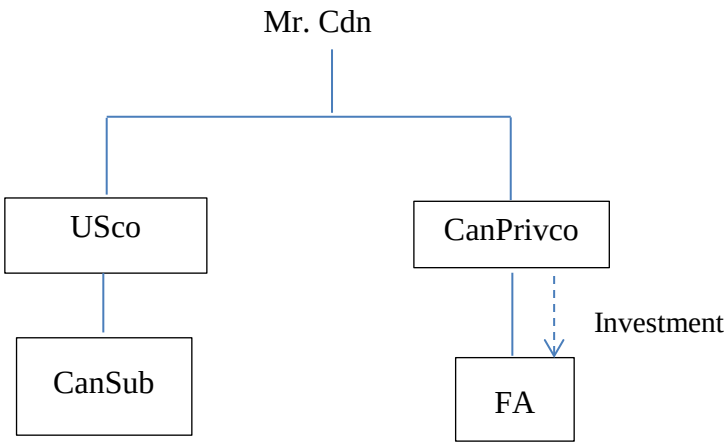
Example 2B (para 251(5)(b))



- Assume Can Bidco has an agreement to acquire all of the shares of CanadianSub from CanPubco.

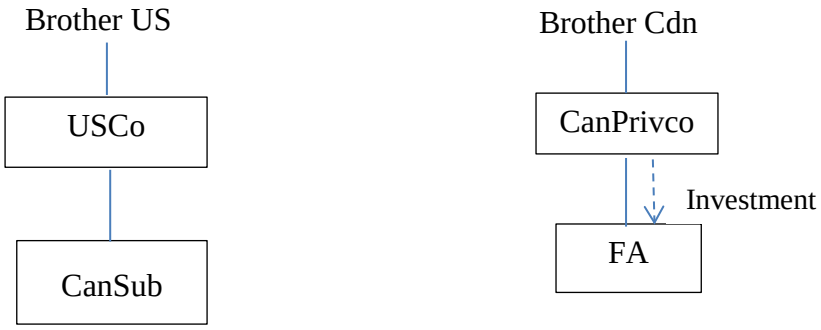
- The FAD rules will apply to CanPubco's investment in FA because CanPubco is related to and therefore NAL with Can Bidco, which is controlled by a non-resident corporation.

Example 3A (related)



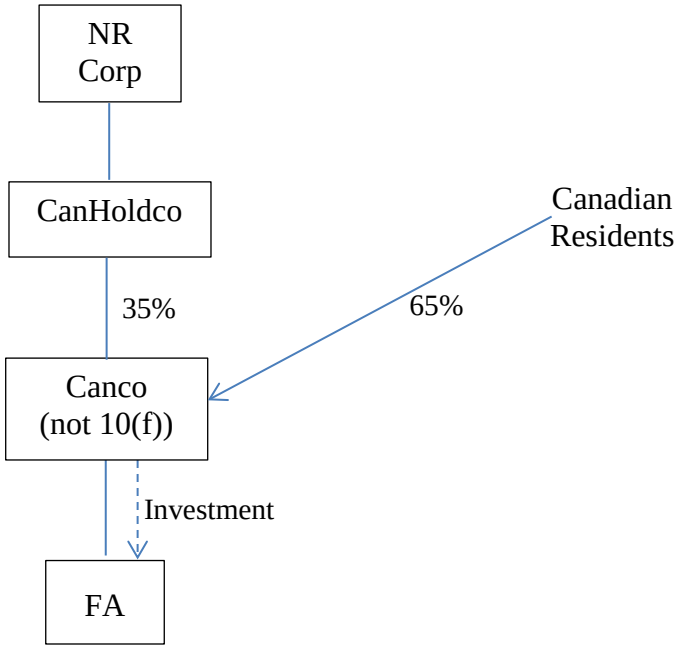
- The FAD rules will apply to CanPrivco's investment in FA because CanPrivco is NAL with CanSub, which is controlled by a non-resident corporation.
- CanSub is not relieved by para 212.3(15)(a) because Mr. Cdn is not a corporation.

Example 3B (related)



- The FAD rules will apply to the investment by CanPrivco in FA because CanPrivco is NAL with CanSub, which is a corporation controlled by a non-resident corporation.

Example 4A (Factual NAL – Never Legal Control)

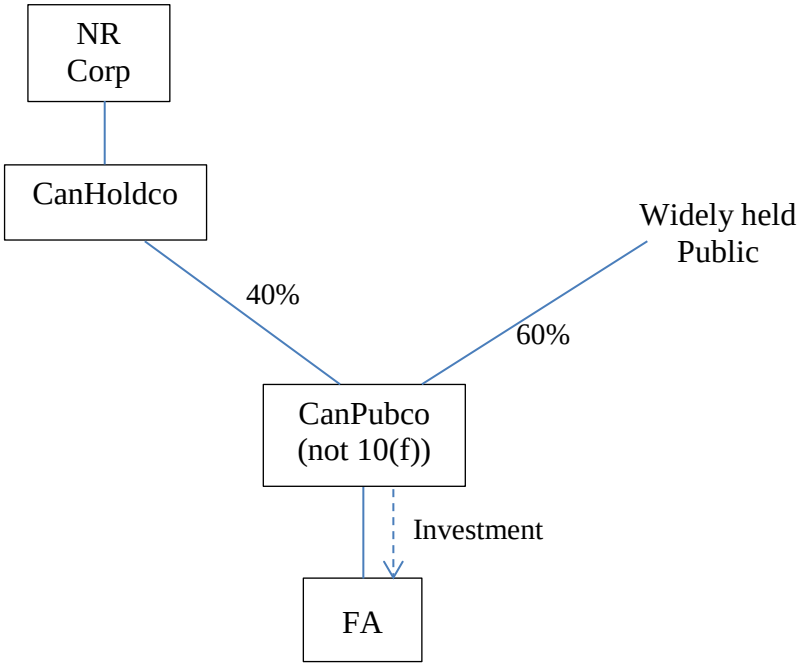


- Assume CanHoldco may be NAL with Canco because of factual circumstances or shareholder agreement rights. However, assume that CanHoldco never obtains legal control of Canco.

- The FAD rules will apply to the investment by Canco into FA because Canco is NAL with CanHoldco which is a corporation controlled by a non-resident corporation.

- Effect is to expand threshold for FAD rules from requiring legal control by a single non-resident corporation (at some point in series) to requiring only a NAL relationship (even if legal control is never acquired). Because FA is a foreign affiliate of both CanHoldco and Canco, rules must be drafted to ensure that NR Corp is not affected by an investment made by Canco in FA.

Example 4B (Factual NAL – Never Legal Control)



- If CanHoldco is considered NAL with CanPubco – due to its significant shareholding and the fact that balance of shares is widely held – FAD rules will apply to CanPubco's investment in FA.