The Joint Committee on Taxation of
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Mr. Brian E. Ernewein
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Dear Mr. Ernewein:

Additional Submission—Proposed Amendments to Foreign Affiliate Rules in February 27, 2004 Draft Legislation (the "Draft Legislation")

We would like to first express our thanks to you and your colleagues for taking the time to meet once again with our Foreign Affiliate Subcommittee (the "Subcommittee") on October 3, 2005. At that meeting, the Subcommittee undertook to provide you with further comments on aspects of the Draft Legislation, and modifications thereto that are under consideration, relating to the treatment under the federal *Income Tax Act* (the "Act") and *Income Tax Regulations* (the "Regulations") of certain foreign affiliate ("FA") distributions. This submission, which contains these comments as well as comments on foreign exchange hedging arrangements, follows our previous submissions of November 3, 2004 and October 8, 2004 on the Draft Legislation and our September 18, 2003 submission on the earlier December 20, 2002 proposed amendments to the foreign affiliate rules.

This submission provides you with our comments with respect to the following three matters:

- ***Foreign Paid-Up Capital.*** The first matter is the basic question of whether or not the characterization of a FA distribution should be determined as a function of the FA's "foreign paid-up capital" ("FPUC"). In this regard, for the reasons set out below, the Joint Committee strongly recommends that the characterization of a FA distribution should not be determined as a function of the FA's FPUC. Rather, the character of a FA distribution should be determined as a function of the FA's underlying surplus accounts, in accordance with the scheme of the Regulations. That scheme, in our view, clearly reflects the principle that, in the FA context, unlike in the domestic context, the "default" treatment for corporate distributions is cost recovery treatment, except to the extent that there exists economic

appreciation reflecting earnings realized after FA status commences, translated into surplus accounts. In this context, FPUC and its domestic analogue, "paid-up capital" ("PUC"), are in our view largely immaterial and often inappropriate measures of the relevant amounts.

- ***FPUC Currency.*** The second matter is the question of which currency such FPUC should be maintained in, assuming such a concept should be introduced. In this regard, and on the basis that FPUC would be introduced as a means of achieving income-measurement objectives, it is our strong recommendation that FPUC should be maintained in the relevant shareholder's calculating currency –Canadian dollars in the case of a taxpayer resident in Canada (and, in certain situations, a FA).

- ***Hedging Arrangement Currency.*** The third matter arises in the context of the proposed amendments relating to foreign exchange hedging arrangements (e.g., proposed paragraph (c.1) of the definition of "excluded property" ("EP") in subsection 95(1), proposed subparagraph 95(2)(a)(vi), and proposed paragraph 95(2)(i)). In this context, we address the question of whether or not there should be any technical limitation on the currency to which a particular foreign exchange exposure (arising in some other currency) could be hedged, and strongly recommend that no such technical limitation be introduced.

We elaborate below on our comments with regard to each of these matters, and include an Appendix that illustrates the operation of our recommended approach.

Foreign Paid-Up Capital (FPUC)

We believe our Subcommittee's discussion with you of the FPUC concept would benefit from revisiting how it evolved, essentially as the measure of the amount (i.e., the cost, as we describe below) of a shareholder's investment in a FA. While PUC has certain connotations for the purposes of the Act, mostly concerning the taxation of Canadian resident corporations and their shareholders more or less on an integrated basis, we suggest and comment below that the same connotations are not typically or even systemically present or appropriate in relation to the taxation of FAs and their shareholders.

We suggest that the FPUC notion has evolved simply as a method for measuring the amount invested by a shareholder in a FA – in effect, as a proxy or measure for the tax-paid cost to a shareholder of FA shares, and in the case of an original investment to acquire treasury shares will align closely if not completely with the adjusted cost base (or "ACB") of those shares to the shareholder, determined in the shareholder's calculating currency. Moreover, as the present proposal for subsection 88(3) as it is developing evidently accepts and does or is expected to reflect, this is the case regardless of whether the invested amount is accounted for by the FA as legal share capital, contributed surplus, share premium or another manifestation of the invested amount. The problem, in our view, arises where the shareholder has in fact incurred or laid out *bona fide* tax-paid cost for FA shares that may not be reflected in its FPUC, or in legal capital reflecting an actual contribution – e.g., where the shareholder acquired the FA shares from another shareholder rather than from treasury, or where the relevant FA has undergone or participated in certain types of capital or other corporate or commercial reorganizations.

We recognize that, from the Department's perspective, this matter to some extent involves the belief that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain, even at the time of ultimate repatriation (i.e., "distributions" into Canada). However, while this principle has been reflected for some time in subsection 93(1.1), this provision has never applied with respect to situations of ultimate repatriation. Thus, to date, the principle that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain at the time of ultimate repatriation has not been reflected in the Act – and, according to our understanding, it is precisely this that the Department proposes to change. Nevertheless, it is also our understanding that this change would not involve the abandonment of the principle that the taxpayer should be permitted to recover its tax-paid investment before recognizing any further income. As a consequence, it would seem to us that these two principles would have to be reconciled appropriately in designing the relevant measure.

Suggested Adjusted Cost Base (ACB) Approach

In this submission, we propose an approach that achieves this objective by adopting ACB (a shareholder concept) rather than PUC (a corporate capital concept) as the best measure of the tax-paid amount invested by a shareholder that may be returned to it without further tax. We suggest that, as a matter of principle, tax-paid cost in this context includes not only the amount paid by a shareholder to subscribe for shares of the issuer, but as well any amounts paid to an unrelated party to acquire such shares. The same interests with respect to the ultimate actual taxation of inherent corporate value and shareholders in the context of the integrated taxation of corporate income, which are served by PUC in the domestic context, simply are not present when dealing with FAs. Indeed, the scheme of the Act and Regulations in this context clearly reflects the principle that an acquiring shareholder of FA shares does not inherit the FA's surplus history from the disposing shareholder, except in certain non-arm's length transfers or reorganizations contemplated by Regulation 5905. Thus, pre-acquisition surplus can and often does reflect what in law or otherwise would constitute corporate "retained earnings". Those pre-acquisition corporate retained earnings are never used in the FA context to determine the character and treatment of FA distributions, since pre-acquisition surplus distributions always give rise to cost recovery treatment for the purposes of the Act and Regulations.

It follows, in our view, that the appropriate measure of the tax-paid invested amount, in the FA context, is cost or ACB from the shareholder's perspective rather than retained earnings or legal capital from the corporation's perspective. To adopt a different approach, we suggest, would in many cases invite double or otherwise inappropriate taxation of the after-tax capital expended by a shareholder to acquire the shares. Thus, while our specific comments which follow proceed on the understanding, based on the Department's perspective, that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain, we believe it is equally important not to abandon the principle that the taxpayer should be permitted to recover its tax-paid investment before recognizing any further income.

Accordingly, assuming that the taxpayer should continue to be permitted to recover its tax-paid investment before recognizing any further income (and assuming that the measure of the taxpayer's investment should be ACB, and that the measure of a FA's relevant undistributed surplus should continue to be "attributed net surplus", as reflected in subsection 93(1.1)), and assuming further that the taxpayer should not be permitted to "convert" undistributed "taxable

surplus" into a capital gain, even at the time of ultimate repatriation, then it would seem to us that any measure introduced in this regard should be engaged only if and to the extent that a capital gain would otherwise arise. As a corollary, if no capital gain would otherwise arise, then it is obvious that the taxpayer would not be "converting" undistributed "taxable surplus" into a capital gain, so no deemed dividends should arise.

What follows from this logic, in our view, is that the Department should consider simply extending the scope of subsection 93(1.1) rather than introducing an additional and inconsistent regime that operates as a function of FPUC. It is submitted that such an extension would be sufficient to address the Department's concerns with respect to the "conversion" of undistributed "taxable surplus" into capital gains, and would be consistent with fundamental aspects of the scheme of the FA rules. For example, subsection 93(1.1) could be extended to circumstances in which the shares of a FA held by a taxpayer resident in Canada are either redeemed, acquired or cancelled by the FA (including on its liquidation and dissolution) or by a person that does not deal at arm's length with the taxpayer, or are deemed to have been disposed of by the taxpayer by reason of subsection 40(3). Under such an extended version of subsection 93(1.1), it would seem to us that it would not be possible for a taxpayer to "convert" undistributed "taxable surplus" into capital gains, and the taxpayer would be permitted to recover its investment (i.e., its ACB) before being required to recognize any income.

Limited Role for PUC in FA Context

In this regard, we submit, as we observed more generally above, that our approach is consistent with the functions performed in the Act of PUC as such, and that those functions and the tax policy underlying the significance of PUC in the domestic context are fundamentally distinguishable with respect to investments in FAs.

- It is our understanding that, in the domestic context, and in the inbound cross-border context (i.e., in the context of a distribution by a corporation resident in Canada), the concept of PUC has been employed in the Act as a means of *indirectly measuring* relevant undistributed corporate surplus. In effect, in this model, undistributed corporate surplus is equated with the difference, if any, between a corporation's PUC and the fair market value of its assets (net of its liabilities). This amount may or may not be reflected in the corporation's retained earnings, in the sense that retained earnings would normally not include any unrealized "appraisal surplus". However, the distribution by the corporation of any amount exceeding its PUC would nevertheless normally be characterized as a dividend pursuant to subsection 84(2), assuming that this provision were applicable in the circumstances, resulting in income recognition rather than cost-recovery treatment. As a corollary, the distribution (by way of a formal return of capital) by the corporation of an amount not exceeding its PUC would normally result in cost-recovery treatment. Similar parameters apply under subsection 84(3). Moreover, this concept is employed as an important element of the various "surplus stripping" rules applicable in relation to a corporation resident in Canada, such as sections 84.1 and 212.1, as a benchmark within which these rules are not engaged. That is, no deemed dividend arises to the extent that the "boot" (i.e., non-share consideration) received by the transferor does not exceed the PUC of the transferred shares. Thus, the principal function of this concept would appear to be to serve, essentially, as an *income measurement tool* – to measure the amounts that are accorded income recognition treatment (i.e., deemed

dividends), rather than cost-recovery treatment, in the context of a distribution by a *corporation resident in Canada*.

- In the context of a distribution by a FA, the concept of PUC has a much more limited function as a practical matter, because of two reasons.

  - First, in the FA context, the Act relies on a very detailed set of rules – the "surplus" computation rules in Part LIX of the Regulations – as a means of *directly measuring* relevant undistributed corporate surplus – which, in this context, does not include appraisal surplus in our view. That is, in this context, in very conceptual terms, we would submit that relevant undistributed corporate surplus includes only *realized* earnings – indeed, only those earnings realized through transactions other than "internal dispositions". Thus, it is not necessary to rely on PUC, or FPUC, in this regard.

  - Second, in our view, relying on PUC, or FPUC, in this regard would be inappropriate, in that it would be inconsistent with the notion that relevant undistributed corporate surplus in this context includes only *realized* earnings (i.e., only FA "surplus"). In other words, in this context, the rules would appear to be (and, in our view, should be) designed as much as possible so as to result in income recognition treatment only in amounts that are reflected in such "surplus", subject to the principle that the taxpayer (or a FA, as the case may be) should be permitted to recover its investment before recognizing any income, to which we will return below. As an illustration of the more general point, we note that both current and proposed Regulation 5902(6), which determines the amount of the deemed dividend arising in the FA context pursuant to subsection 93(1.1), provides for income recognition treatment only in the amount equal to the *lesser of*:

    - the *capital gain*, if any, otherwise determined in respect of the disposition of the relevant share,

    and

    - the amount that could reasonably be expected to have been received in respect of the share if the particular affiliate had at the relevant time paid dividends the aggregate of which on all shares of its capital stock was equal to the amount determined under Regulation 5902(1)(a) to be its *"net surplus"* in respect of the corporation (or, under the Draft Legislation, the amount of *"attributed net surplus"* (as determined under proposed Regulation 5902(1)(f)) in respect of the relevant share), determined on a consolidated basis.

    In other words, even the "surplus stripping" rules applicable in the FA context do not rely on PUC as a means of determining the amounts that should be accorded income recognition treatment. Rather, in the FA context, this determination is made as a function of "surplus" and "basis" (i.e., ACB), being a central determinant of capital gain). Indeed, PUC has nothing at all to do with the application of the surplus

stripping rule in subsection 93(1.1). Similarly, the relevant income measurement and surplus stripping rules in the Act that do rely on PUC (i.e., those in sections 84, 84.1 and 212.1) are deliberately disapplied in the FA context. For example, where FA1 disposes of FA2 for $100 at a time when FA1's ACB in the FA2 shares is nil and FA2 has $50 of "surplus" and no PUC, only $50 of deemed dividends would arise – not $100 as would be the case if PUC were the relevant benchmark. Likewise, where FA1 disposes of FA2 for $100 at a time when the underlying attributes are the same as just mentioned except that FA2 has $100 of PUC, $50 of deemed dividends would still arise – not *nil* deemed dividends as would be the case if PUC were the relevant benchmark. Thus, PUC (and, in our view, FPUC) simply is not (and, in our view, should not be) relevant in this regard. Rather, since the relevant (and direct) measure of undistributed corporate surplus in this context is FA "surplus", the relevant measure of the taxpayer's investment in the FA becomes ACB – once again, not PUC or FPUC. In this manner, the taxpayer is accorded (or, rather, subjected to) income recognition treatment (i.e., deemed dividends) only if and to the extent that the relevant affiliate has "attributed net surplus" in an amount that exceeds the taxpayer's investment (i.e., its ACB) in respect of the relevant shares. It is submitted that it would be inconsistent with this well developed infrastructure to now introduce a measure that would operate to produce deemed dividends in this context as a function of an affiliate's FPUC. Indeed, such a measure would seem to us to directly conflict with, and to produce results that would be inconsistent with those arising under, the regime reflected in current and proposed Regulation 5902(6).

- Thus, while PUC still plays a role under current rules in the context of FA distributions, that role is largely redundant, in that a FA distribution made in the form of a "return of PUC" is accorded essentially the same treatment as a FA distribution in the form of a dividend out of "pre-acquisition surplus", with two important exceptions.

    - A FA distribution made in the form of a "return of PUC" is accorded cost-recovery treatment in accordance with common law principles (to the effect that the distribution does not result in the recognition of income by the shareholder) and pursuant to subparagraph 53(2)(b)(ii). A FA distribution in the form of a dividend out of "pre-acquisition surplus" is also accorded cost-recovery treatment – in accordance with paragraph 113(1)(d), subsection 92(2) and subparagraph 53(2)(b)(i).

    - However, whereas a "return of PUC" can be used to "bypass" undistributed "taxable surplus" (subject to certain "exceptions"), a dividend out of "pre-acquisition surplus" arises only after "taxable surplus" has been depleted. We refer to "exceptions" to indicate that a "return of PUC" cannot be used to "bypass" undistributed "taxable surplus" if it results in a deemed disposition of the relevant shares under subsection 40(3), because the "return of PUC" exceeds the relevant ACB, and subsection 93(1.1) is applicable. In such a case, a deemed dividend would arise, thereby capturing the "taxable surplus". Nevertheless, a "return of PUC" can be used to "bypass" undistributed "taxable surplus" in all cases where there is sufficient ACB, which is appropriate in our view. Moreover, a "return of PUC" can be used to "convert" undistributed "taxable surplus" into a capital gain where the distribution is governed by subsection 88(3), or where the relevant shares are not EP, even where the

distribution exceeds ACB, since subsection 93(1.1) does not currently apply in either case. We will return to this issue below.

— Another important difference is that, in the context of a "return of PUC", no relief whatsoever is provided for under the Act in respect of any applicable foreign withholding taxes. In contrast, in the context of a dividend out of "pre-acquisition surplus", the ACB reduction provided for under subsection 92(2) is itself reduced by any applicable foreign withholding taxes, thereby granting relief under the Act in the form of latent loss (or less latent gain) on the relevant shares, given that such dividends do not constitute "exempt dividends" as defined in subsection 93(3) for the purposes of the stop-loss rule in subsection 93(2). Thus, assuming that there is no material undistributed "taxable surplus", the taxpayer would have an incentive under the Act to cause the distribution to be made in the form of a dividend out of "pre-acquisition surplus", if that would result in relief for any foreign withholding taxes that would be applicable in either case. Of course, if a "return of PUC" would in the first place avoid the application of foreign withholding taxes, that would remain the preferred form of distribution from a Canadian perspective, since the avoidance of foreign withholding tax would always be preferable to the limited form of relief in that regard provided for under subsection 92(2).

- It would seem to us that a regime that relies on FPUC would almost invariably violate at least one of the two principles intrinsic to the FA system even as it would be modified by proposed changes to the FA rules, and would give rise to inequitable results in many cases. For example, where a taxpayer acquires a FA from a third party and the FA has FPUC that exceeds its FMV at that time, a regime that relies on FPUC could put the taxpayer in a position to enjoy a tax benefit windfall at some point in the future, in allowing the taxpayer to "convert" undistributed "taxable surplus" into a capital gain by making an FPUC distribution that exceeds ACB. Similarly, and unless remedial action is taken, where a taxpayer acquires a FA from a third party and the FA has FPUC that is lower that its FMV at that time, a regime that relies on FPUC could put the taxpayer in a position to suffer a tax disadvantage at some point in the future, in that the taxpayer would not be permitted to recover its actual investment (i.e., its ACB) before being required to recognize income.

Recommendations

Against that background, and as a means of mechanically implementing these principles, our recommendations are as follows. A number of examples of the application of the regime described below are set forth in the Appendix.

1. Where shares of a FA held by a taxpayer resident in Canada are redeemed, acquired or cancelled by the FA (including on its liquidation and dissolution, or on a merger) or by a person that does not deal at arm's length with the taxpayer, the position would be mandatory (i.e., the extended subsection 93(1.1) would be engaged) and would provide for income recognition treatment (i.e., deemed dividends) to the extent of the lesser of the amount of any capital gain otherwise resulting from the disposition and the amount of the relevant "attributed net surplus", and would provide for cost-recovery treatment (i.e., proceeds of disposition or deductions from ACB) for the balance.

2. Where a dividend payment or other distribution of property (excluding, for greater certainty, any transaction described in the preceding paragraph) is made by a FA, the position would be elective, with income recognition treatment (i.e., an actual or deemed dividend) being the default position. That is, the distribution would either be or would in any event be treated as a dividend, except to the extent that the taxpayer designated that all or part of the amount of the distribution should be accorded cost-recovery treatment (i.e., deducted from ACB). If the amount of the distribution that is designated for cost-recovery treatment exceeds the taxpayer's ACB in the relevant shares, then a capital gain would arise under subsection 40(3), and dealt with as described below. Although we have struggled with this notion to some extent, we ultimately concluded that an elective mechanism would be most neutral, most efficient and most equitable in the circumstances. In particular, we note that, since there would be a difference between FPUC and corporate legal character if an FPUC regime were introduced as contemplated, some type of mechanical rule would have to be introduced to determine when a distribution that in law is made in the form of a dividend should be treated as a distribution of FPUC. In this regard, we understand you are considering the use of a designation mechanism. Inspired by this approach, we suggest a designation mechanism be used for all dividends or other distributions. This would be most efficient, as time and expense would not have to be spent by taxpayers or the tax administration trying to characterize the distribution as a matter of foreign corporate law. Also, this would be most neutral and most equitable, since it would eliminate the possibility of anomalies in Canadian tax treatment resulting from differences in the foreign corporate laws of various countries. Moreover, it would eliminate the possibility of anomalies in Canadian tax treatment resulting from differences in the foreign tax laws of various countries (ie, taxpayers often prefer to capitalize FAs without creating formal legal capital, as a means of minimizing foreign capital duties).

3. Where a taxpayer is deemed to have realized a capital gain under subsection 40(3) because of a cost-recovery designation (as opposed to because of the "attributed net surplus" of the relevant FA having been depleted), the extended subsection 93(1.1) would be engaged, such that the taxpayer would be precluded from 'converting" undistributed "taxable surplus" into a capital gain. In contrast, where a taxpayer is deemed to have realized a capital gain under subsection 40(3) but the "attributed net surplus" of the relevant FA has been depleted, a capital gain would quite properly arise.

4. The "amount" of the distribution (whether ultimately accorded income recognition treatment or cost-recovery treatment) would be determined largely as described in the Draft Legislation (i.e., in certain cases, as a function of whether or not EP is being distributed; in certain cases, as a function of the taxpayer's percentage equity interest in the relevant FA – such as under proposed paragraph 95(2)(e.1); in certain cases, as a function of the nature of the transaction – such as in the case of a "foreign merger" governed by the broader form of paragraph 95(2)(d.1) currently under consideration, etc.).

5. A similar approach would be taken in the context of inter-affiliate distributions and analogous transactions. Subsection 93(1.1) would be applicable as a matter of course in respect of share dispositions, and otherwise distributions would result in deemed dividends subject to the taxpayer's cost-recovery treatment designation.

6. Reorganizations of capital and share-for-share exchanges with issuer FAs (e.g., transactions to which section 51 or 86 is applicable) would be excluded from the scope of a "distribution" as such, but would engage the application of subsection 93(1.1) to the extent that a capital gain would otherwise arise and there is "attributed net surplus".

Finally, we would note in this regard that the introduction of such a broad deemed dividend/cost-recovery designation regime would seem to us to be perfectly consistent in fundamental respects with the notion of recharacterizing proceeds of disposition as deemed dividends under subsection 93(1.1) or otherwise. For example, both under existing rules and under the Draft Legislation, the treatment of a share redemption is not constrained by foreign corporate and commercial law, in the sense that the Act generally permits under subsection 93(1) and in certain cases requires under subsection 93(1.1) that what would otherwise be characterized as proceeds be recharacterized as dividends. A broad deemed dividend/cost-recovery designation regime would seem to us to be analogous – and would facilitate efficient administration of and compliance with the Act. In the latter regard, we would submit that any regime that can "piggy-back" off existing infrastructure in the Act and Regulations would be preferable to one that would require the development of new concepts and the tracking of information that is not otherwise useful. Thus, our recommended approach has been designed to operate on the basis of information that is already required to be maintained and serves various material purposes – namely, ACB and "surplus". In contrast, the adoption of a new regime that operates on the basis of FPUC would not only require the introduction of this new concept (which, in itself, is probably not that material) but also would require the gathering and maintenance of information dating back to the creation of the relevant FAs, which could impose material and, in certain cases, insurmountable administrative and compliance burdens on all concerned, particularly in circumstances where a taxpayer has acquired a FA that has undergone or participated in share capital or other corporate and commercial reorganizations, which can result in changes to legal capital accounts without corresponding contributions or distributions.

FPUC Currency

Assuming that the FPUC regime should be introduced, a related question that arises is which currency such FPUC should be maintained in. In this regard, it is our submission that such FPUC should be maintained in the currency that is relevant in computing the affected shareholder's income or capital gain from a disposition of the relevant FA shares. Our view in this regard is based on the proposition that such FPUC would be intended to serve as an indirect (if inaccurate) measure of the amounts that should be accorded income recognition treatment in the context of a distribution of relevant undistributed corporate surplus, and the principle that the taxpayer should be permitted to recover its investment before being required to recognize any income. Assuming this principle is relevant here, it would seem to us to be appropriate that a significant element of the taxpayer's income determination such as FPUC should accordingly be maintained in the same currency.

This approach would also appear to minimize inefficiencies and other arguably inappropriate results that can arise because of fluctuations in the value of the currency in which the FPUC is maintained relative to the value of the shareholder's relevant currency. For example, if FPUC were maintained in a currency other than the shareholder's relevant currency, then an increase in

value of that currency, relative to the value of the shareholder's relevant currency, would increase the amount that could be received by the shareholder as a "return of FPUC" – free of income recognition (i.e., free of deemed dividends), thereby permitting the taxpayer to "convert" a distribution of "taxable surplus" into a capital gain to this extent. Thus, if a Canadian-resident shareholder invested $100 in the capital of a FA, maintaining the resulting FPUC in Canadian dollars would ensure that the shareholder could recover no more and no less than that initial $100 on a cost-recovery basis. In contrast, maintaining that FPUC in another currency would virtually always result in "slippage". If the value of that other currency increased relative to the Canadian dollar, such that the value of the relevant foreign currency units increased, say, from $100 to $150, then the FA could distribute an "amount" equal to $150 to the shareholder as a "return of FPUC", thereby permitting the "conversion" of $50 of "taxable surplus" into a capital gain. Conversely, the shareholder's interests can be adversely affected by a currency movement in the opposite direction, in that the shareholder might not be able to receive its initial investment of $100 as a "return of FPUC" (depending on how distributions would be characterized for this purpose), since the value in Canadian dollars at that time of the FPUC would be less than $100.

Hedging Arrangement Currency

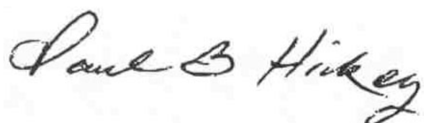
In our submission to you dated September 18, 2003, in relation to the December 20, 2002 version of the proposed amendments, we recommended that certain clarifications and other revisions be made with respect to the proposed amendments relating to foreign exchange hedging arrangements (e.g., proposed paragraph (c.1) of the definition of "excluded property" in subsection 95(1), proposed subparagraph 95(2)(a)(vi), and proposed paragraph 95(2)(i)). In particular, we recommended that the language of these provisions be clarified by providing that a hedging arrangement would qualify under these rules (assuming other relevant conditions were satisfied) if it was entered into by the relevant FA "to reduce its risk, with respect to an amount …, of fluctuations in the value of the currency in which the amount was denominated *relative to any other currency*". Given that the version of these proposals in the Draft Legislation, in relevant part, is effectively the same as the prior version, we reiterate our recommendation in this regard.

Moreover, we note that it would strike us as being anomalous that the combined effect of the FA financing and hedging rules would be to accommodate a situation in which, for example, one FA makes a loan to another FA in a particular currency other than the lender's calculating currency (e.g., the currency in which the lender has issued funding obligations (the "funding currency")) but would not accommodate the analogous and functionally equivalent situation in which the loan is made in a currency other than the lender's calculating currency and other than the funding currency (e.g., the borrower's currency, where that differs), and the lender then hedges its exposure with reference to the risk of fluctuations in the value of the borrower's currency relative to the value of the funding currency by "swapping" its "long" exposure to the borrower's currency for "long" exposure to the funding currency, or *vice versa*. In the first case, the lender would have created a "natural hedge" by lending in the funding currency. In the second case, since the lender would have made the loan in the borrower's currency, there would not be any "natural hedge", but the lender would have created an equally perfect hedge by "swapping" its "long" exposure to the borrower's currency for "long" exposure to the funding currency. In other words, if there is no restriction on the currency in which a qualifying 95(2)(a)(ii) asset can

be initially denominated or subsequently redenominated, then it would seem to us to be anomalous that there should be any restriction on the currency in which a qualifying hedging arrangement can be denominated.

We would be pleased to elaborate on our thoughts in this regard, including with respect to transitional issues, should you consider it to be advisable to consult with us further in this regard.

Yours truly,



Paul B. Hickey, CA
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Cc: Wally Conway – Department of Finance

Appendix

Example 1 – Legitimate Bypassing of Undistributed Taxable Surplus

Facts:

- Canco acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing “taxable surplus”) of $50
- CFA “capitalizes” its undistributed retained earnings
- CFA distributes an “amount” that does not exceed Canco’s ACB – say, $100

Consequences:

- No deemed dividend or other consequence when CFA “capitalizes” its undistributed retained earnings
- Canco would be deemed to receive a dividend of $100 (thus, $50 out of “taxable surplus” and $50 out of “pre-acquisition surplus”), unless Canco elected cost-recovery treatment for the entire “amount”, in which case no deemed dividend or capital gain would arise, but Canco’s ACB would be completely depleted – Canco would have fully recovered its investment of $100, but no more than that.

Example 2 – Capitalization of Undistributed Taxable Surplus

Facts:

- Canco acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing “taxable surplus”) of $50
- CFA “capitalizes” its undistributed retained earnings
- CFA distributes an “amount” that exceeds Canco’s ACB – say, $125

Consequences:

- No deemed dividend or other consequence when CFA “capitalizes” its undistributed retained earnings
- Canco would be deemed to receive a dividend of $125 (thus, $50 out of “taxable surplus” and $75 out of “pre-acquisition surplus”), unless Canco elected cost-recovery treatment for at least the portion of the “amount” that is within its ACB (which is assumed), in which case a deemed dividend of $25 (out of “taxable surplus”) would arise. No capital gain would arise, but Canco’s ACB would be completely depleted. Thus, Canco would have fully recovered its investment $100, and recognized a return on investment of $25, accounted for as a dividend out of “taxable surplus”.

Example 3 – Stripping of Undistributed Taxable Surplus

Facts:

- Canco1 acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing "taxable surplus") of $50
- Canco1 transfers CFA to Canco2 (a wholly-owned subsidiary) in exchange for shares of Canco2 and cash in an amount that exceeds Canco1's ACB – say, $125 (such that a section 85 election is duly made for $125, where FMV is $150)
- CFA distributes an "amount" that exceeds Canco2's ACB – say, $150

Consequences:

- No deemed dividend or other consequence when CFA "capitalizes" its undistributed retained earnings
- On the transfer by Canco1 to Canco2, Canco1 would be deemed to receive a dividend of $25 (out of "taxable surplus"), and this amount would be excluded from its proceeds of disposition of the CFA shares, such that no gain would arise. Canco2's ACB would be $125. Moreover, CFA's "taxable surplus" would be reduced by $25 to $25.
- On the subsequent distribution to Canco2, Canco2 would be deemed to receive a dividend of $150 (thus, $25 out of "taxable surplus" and $125 out of "pre-acquisition surplus"), unless Canco2 elected cost-recovery treatment for the entire "amount" of the distribution, in which case it would still be left with a deemed dividend of $25 out of "taxable surplus". That is, if Canco2 elected cost-recovery treatment for the entire "amount" of the distribution, what would happen is that it would be deemed to have a gain of $25 under subsection 40(3), such that subsection 93(1.1) would apply to result in a deemed dividend of $25 out of "taxable surplus".

Example 4 – Stripping of Undistributed Taxable Surplus

Facts:

- Same as Example 3, except CFA already had PUC of $200 when it was acquired by Canco1, so no "capitalization" is made of its undistributed retained earnings

Consequences:

- Same as Example 3. In contrast, we note that an FPUC regime along the lines of that under consideration would seem to permit the undistributed "taxable surplus" in such a case to be "converted" to capital gains – $25 in the hands of each of Canco 1 and Canco 2 – unless further supporting deemed dividend provisions are introduced, to address "capitalizations", "stripping" transactions, and similar arrangements.