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2011-2012 OFFICERS

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Dear Ms. Horsman:

On August 19, 2011, the Department of Finance released a package of legislative proposals (hereinafter “the 2011 proposals or the proposals”) to amend the foreign affiliate rules in the *Income Tax Act, Canada* (the Act) and the *Income Tax Regulations* (the Regulations). On behalf of Tax Executives Institute, I am writing to provide the Institute’s comments on the proposals.

Background on Tax Executives Institute

Tax Executives Institute is the preeminent international association of business tax executives. The Institute’s 7,000 professionals manage the tax affairs of 3,000 of the leading companies in North America, Europe, and Asia. Canadians constitute 10 percent of TEI’s membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver, which together make up one of our nine geographic regions, and must contend daily with the planning and compliance aspects of Canada’s business tax laws. Many of our non-Canadian members (including those in Europe and Asia) work for companies with substantial activities in Canada. The comments set forth in this letter reflect the views of the Institute as a whole, but more particularly those of our Canadian constituency.

TEI concerns itself with important issues of tax policy and administration and is dedicated to working with government agencies to reduce

the costs and burdens of tax compliance and administration to our common benefit. In furtherance of this goal, TEI supports efforts to improve the tax laws and their administration at all levels of government. We believe that the diversity and professional training of our members enable us to bring a balanced and practical perspective to the issues raised by the August 19, 2011, draft legislation on foreign affiliates.

General

The current proposals generally supplant the draft foreign affiliate legislation released on February 27, 2004 (the 2004 proposals) and supplement changes proposed on August 27, 2010. Overall, the 2011 proposals represent an improvement over the 2004 proposals and we commend the Department for responding positively to the concerns of stakeholders, including TEI, about the 2004 proposals. Regrettably, notwithstanding the improvements, some of the proposed measures are unworkable while others constitute a shift in tax policy that should either be abandoned or significantly revised. Specific comments in respect of the August 19, 2011, draft foreign affiliate proposals follow below.

More broadly, TEI regrets that the 2011 proposals do not implement the 2008 recommendations of the Advisory Panel on Canada's System of International Taxation to (1) broaden the exemption system to include all foreign active business income earned by foreign affiliates and (2) extend the exemption system to capital gains and losses realized on the disposition of shares of a foreign affiliate that derive all or substantially all their value from active business assets.¹ Despite the government's economic priority to ensure that Canada maintains one of the most competitive tax systems among the G7 countries, other countries, the United Kingdom especially, have moved farther and faster than Canada in respect of the treatment of active business income of foreign affiliates.

Upstream Loans

Section 90 of the Act includes in the income of a taxpayer resident in Canada any dividends received from a non-resident corporation. The Explanatory Notes to the 2011 proposals state that "section 90 is being significantly expanded to provide, among other things, specific rules for dividends from foreign affiliates and to address avoidance techniques involving so called 'upstream loans'." Specifically, proposed subsections 90(4) to (10) of the Act would introduce a series of "anti-avoidance rules designed to prevent taxpayers from making synthetic dividend distributions from foreign affiliates in order to avoid what would otherwise be income inclusions under new subsection 90(1) that are not fully offset by deductions under paragraphs 113(1)(a) to (b) of the Act."²

¹ See *Enhancing Canada's International Tax Advantage*, Final Report of the Advisory Panel on Canada's System of International Taxation (December 2008), Recommendations 4.1 and 4.3, respectively, at pages 26 and 30.

² *Explanatory Notes — Foreign Affiliate Amendments*, Department of Finance, Canada (August 19, 2011), at pages 17-18.

A. *General*

TEI submits that the policy shift in respect of upstream loans to Canada will (1) restrict the ability of Canadian multinationals to redeploy capital into Canada, (2) encourage the redeployment and investment of foreign affiliate capital offshore, and (3) encourage Canadian multinationals to borrow from third parties, likely non-residents, in order to replace this current source of financing. Moreover, the description of upstream loans as an “avoidance” technique in the Explanatory Notes is at odds with Canada Revenue Agency (CRA) having issued rulings condoning certain forms of upstream loans by corporate groups.

TEI believes the upstream loan rules will introduce inordinate complexity into the tax system, increase the cost of funding to Canadian companies,³ and represent an overbroad response to the tax policy and administrative issues the Department is seeking to remedy. The proposals overlap and are duplicative of, but have more draconian tax consequences, than current anti-avoidance provisions. As important, the rules are so broad that “downstream” and brother-to-sister loans are unnecessarily caught in addition to “upstream” loans of low-taxed foreign affiliate surplus.⁴ In addition, the proposals have technical flaws that should be addressed. Finally, many companies have made long-term commitments of the loan proceeds that cannot be easily or inexpensively replaced within the two-year transition period. Hence, rather than creating a “rebirth” rule for loans outstanding at August 19, 2011, the legislation, at a minimum, should include a permanent grandfather provision for loans outstanding on that date.

There are three fundamental technical flaws in the proposed upstream loan provisions. First, proposed paragraph 90(6)(a) provides relief from dividend treatment where the amount of the debt can otherwise be distributed as a dividend and a deduction would be available under paragraphs 113(1)(a) to (b). Essentially, a taxpayer will be afforded relief where there is either sufficient exempt surplus or sufficient hybrid or taxable surplus with adequate underlying foreign tax. There is seemingly no valid policy rationale, however, for omitting relief where the shareholder has an adjusted cost base (ACB) in the shares of a foreign affiliate that could be returned as pre-acquisition surplus. We recommend modifying the proposals to preclude an income inclusion for upstream loans to the extent of the amount of the ACB plus amounts qualifying for deduction under paragraphs 113(1)(a), (a.1), and (b). In addition, draft paragraph 90(6)(a) should be modified to afford a deduction where a hypothetical distribution of the specified amount would be deductible under subsection 91(5). Otherwise, there would be double taxation of Foreign Accrual Property Income (FAPI) where such amounts are loaned rather than distributed.

³ Upstream loans into Canada are often made on a non-interest bearing basis as a low-cost source of funds for Canadian operations. The 2011 proposals would likely impel Canadian companies to borrow at interest (which will be deductible and, if from non-resident lenders, bear no Canadian withholding tax) instead of borrowing from their affiliates. This would both increase Canadian company costs and potentially decrease the Canadian tax base.

⁴ Moreover, a cascading series of income inclusions can arise where one foreign affiliate in a corporate group with excess cash makes a loan to another foreign affiliate within the group, which, in turn, makes loans to other foreign affiliates. TEI does not believe that one pool of cash funding a chain of loans within a group of companies should result in multiple income inclusions.

Second, proposed paragraph 90(6)(b) “turns off” the relief for upstream loans where the foreign affiliate pays an actual dividend to the Canadian taxpayer or another non-arm’s length resident in Canada, *even where the foreign affiliate has sufficient surplus to satisfy the conditions of proposed paragraph 90(6)(a)*. For example, assume a foreign affiliate has exempt surplus of \$150 and makes a loan of \$100. Under the proposals, the foreign affiliate can make a second loan of up to \$50 but if it paid a dividend of \$50 after the \$100 loan is made the entire \$150 would be taxed. Paradoxically, the result is contrary to the policy goal of the draft legislation of encouraging dividend distributions. We believe paragraph 90(6)(b) is unduly stringent and urge the Department to re-craft the rules and apply concepts similar to those in draft paragraph 90(6)(a) when dividends are paid while an upstream loan is in place.

Third, the upstream loan proposal fails to take account of cash-pooling arrangements commonly undertaken by multinational enterprises. Short-term cash surpluses in affiliates are often lent to related group “cash pooling” entities, which may not be controlled by a Canadian parent (*e.g.*, where the ultimate parent is a non-resident). Under a provision introduced in 2009, interest income earned on such balances is taxable in Canada as FAPI where a Canadian taxpayer in the chain owns less than a 10-percent interest in the borrowing affiliate. TEI believes the 2009 change provides adequate protection for the Canadian tax base and that the proposed carve-out from the income inclusion relief will inadvertently lead to treating temporary cash surplus loans as part of a series of loans taxable in Canada. Such a result will disrupt normal business operations and lead to unwarranted inefficiencies in related group financing arrangements. The government can eliminate the inappropriate deferral of Canadian tax without impeding business operations and subjecting temporary cash surpluses to Canadian taxation by incorporating a purpose test in proposed paragraph 90(5)(a), as follows (additions in italics):

(a) A loan or indebtedness that is repaid, other than as part of a series of loans or other transactions and repayments *the principal purpose of which is to avoid the application of subsection (4)*, within two years of the day the loan was made or the indebtedness arose; or

B. *Related Foreign Entity Finance (RFEF) Structures.*

RFEF structures are used by Canadian companies to redeploy excess funds (on which Canadian corporate income tax has already been paid) by making equity investments in the shares of a controlled foreign affiliate that, in turn, loans the funds to foreign companies that are not foreign affiliates. The Canadian company’s adjusted cost base in the shares of the controlled foreign affiliate often approximates the amount of loans made by the controlled foreign affiliate. As important, interest income earned by the controlled foreign affiliate on the loans will be FAPI income taxable to the Canadian parent and, because of the FAPI inclusion, no income inclusion will arise under subsection 17(1) (assuming the proposed amendment to subparagraph 17(1)(b)(iii) is adopted). CRA has confirmed the tax results to RFEFs in multiple rulings.

As drafted, the upstream loan proposals will apply to the loans made by a controlled foreign affiliate since the borrowing companies will be considered “specified debtors” within the meaning of proposed subsection 90(10). The only way to avoid an income inclusion under

proposed subsection 90(4) would be for the foreign company to repay the loan to the controlled foreign affiliate within two years.

TEI opposes the proposals to tax RFEF loans because section 91 and subsection 17(2) provide effective anti-deferral mechanisms to protect the Canadian tax base. Subjecting the loan amount to tax is also contrary to Canada's general policy of permitting taxpayers to recover the adjusted cost base in their foreign investments on a tax-free basis. In addition, the relieving deduction provided under proposed subsection 90(9) will be of limited effect since it may be difficult to arrange repayment of existing loans within the two-year time frame.⁵

After CRA confirmed that RFEF structures were acceptable, many taxpayers arranged for their controlled foreign affiliates to make long-term loan commitments. Moreover, many borrowers likely invested the loan proceeds in operating assets and may not have the liquidity (or the borrowing capacity) to repay the loans early. In addition, under the terms of the loan, the controlled foreign affiliate may not be able to call the loans for repayment — and the foreign company may be precluded from repaying — within the prescribed two-year period. Finally, prepayment of the loans may trigger other collateral tax consequences to the taxpayer and the borrower — whether in the form of gains or losses on changes in the value of the loan (because of changes in interest rates), foreign exchange gains or losses, or other circumstances. Thus, the application of the proposals to loans outstanding on August 19, 2011, will result in adverse tax consequences that taxpayers may not be able to avoid. In addition to grandfathering existing loans, we recommend that the Department narrow the application of the proposed rules so that financing arrangements such as RFEFs are not caught.

Underlying Foreign Tax

The proposed rules treating upstream loans as dividends will effectively eliminate a self-help mechanism that taxpayers have employed to address a shortcoming in the Act and Regulations relating to the treatment of underlying foreign tax (UFT).⁶ The proposed upstream loan rules in effect compel the payment of dividends to Canada from taxable surplus. To the extent that UFT on the dividend is insufficient, the dividend will be taxable in Canada. Even where the foreign affiliate makes compensating payments that might otherwise be considered foreign accrual

⁵ In addition, if the taxpayer cannot carry back the deduction to the year of the loan's inclusion, the taxpayer may not be able to utilize the non-capital loss the deduction may create.

⁶ In certain circumstances, when a foreign affiliate is a member of a group in a foreign country that determines its income or profits tax on a consolidated or combined basis, the "primary" member of a group (*i.e.*, the taxpayer making payments of tax liability to the foreign government) may not be a foreign affiliate of a corporation resident in Canada while the secondary member may be a foreign affiliate of a corporation resident in Canada. When the primary member pays the foreign income or profits tax on behalf of the group, a secondary member will often make a compensating payment to the primary member in respect of the taxes the secondary member would have paid had it not been a member of the group. Since all the members of the consolidated group are not foreign affiliates of a corporation resident in Canada, subsection 5907(1.1) of the Income Tax Regulations does not apply and the compensating payments made by the secondary member to the primary member will not be considered UFT. This result differs from the rules in respect of FAT. Compensatory payments made by a *controlled* foreign affiliate (CFA) to a non-foreign affiliate member of a consolidated foreign group are considered FAT and thus can be deducted where the controlled foreign affiliate has FAPI that is taxed to a Canadian taxpayer.

tax (FAT) the compensating payments will not be considered UFT. The proposed rules on upstream loans thus exacerbate the issues currently arising under subsection 5907(1.1) of the Regulations.

In addition, many foreign affiliates in an active oil and gas business would likely have incurred sufficient UFT to offset taxable dividend distributions if the proposed “foreign oil and gas levies” rules (*i.e.*, proposed Regulation 5910 announced in the 2010 draft foreign affiliate package, which supersedes similar proposals made in 2000 and 2002) had been implemented. It would be unfair to tax such taxpayers under the 2011 proposals simply because a lag in the legislative process compelled them to rely on upstream loans to avoid double taxation on the foreign earnings.

We recommend that the Department revisit subsection 5907(1.1) of the Regulations and apply the rules to a foreign affiliate of a taxpayer in every circumstance where the foreign affiliate is a member of a group that determines income or profits tax in respect of the foreign country on a consolidated or combined basis.

Dividend Stop-Loss Rule

Subsection 93(2) of the Act includes a stop-loss rule that prevents a Canadian resident corporation from recognizing a capital loss on the disposition of shares of a foreign affiliate that gives rise to exempt earnings. The rule also applies when a foreign affiliate of a corporation resident in Canada incurs a loss on shares of another foreign affiliate that are not “excluded property.” The 2004 proposals provide relieving amendments designed to restore, in some circumstances, the portion of the loss that would otherwise be denied under subsections 93(2) to (2.3) to the extent that a related foreign exchange gain is realized, but those proposals suffered from several technical deficiencies.

Draft subsections 93(2) to (2.32) of the 2011 proposals would similarly permit a portion of the loss on the shares that relates to foreign currency fluctuations to be recognized in some cases. Under proposed clauses 93(2.01)(b)(ii)(A) and (B), a taxpayer may recognize a foreign exchange loss on a hedge of foreign affiliate shares where it enters into the hedge within 30 days of the purchase of the shares and settles the hedge within 30 days of the disposition of the shares. Although the 2011 proposals are better than the 2004 proposals, they do not provide relief for many common business hedging approaches.

At the time of acquiring the shares of a foreign affiliate, a Canadian taxpayer will rarely, if ever, be able to predict the date the shares will be disposed. Moreover, hedging strategies for long-term investments of indefinite duration in foreign businesses are often dynamic, with multiple hedging transactions — whether through “resets” or “rollovers” — undertaken during the holding period of the underlying investment. Indeed, the proposed rules seemingly fail to accommodate the substitution of a new hedging arrangement for the initial hedge or a refinancing (and corresponding hedge) of the borrowings for the purchase of the foreign affiliate shares. As a result, it will be nearly impossible to craft *effective* business hedging strategies that satisfy the 30-day windows of the proposed rules.

To improve the proposed rules, TEI recommends eliminating the time restriction on the period preceding the disposition of the affiliate shares during which a corresponding hedge can be unwound. With respect to hedges unwound after the disposition of shares, the 30-day window is too short to accommodate many hedging transactions. One solution would be to *deem* a hedge to be unwound within 30 days after (or such shorter period as would still be within the same taxation year) the shares are disposed of.

More broadly, TEI believes that the Act should be revamped in order to better address commercial hedging transactions. We would be pleased to consult with the Department to design a comprehensive solution for the appropriate recognition (or deferral) of gains and losses arising from day-to-day hedging transactions.

Absorptive Mergers

Proposed subsection 95(4.2) modifies and substantially clarifies the circumstances under which certain foreign absorptive mergers will qualify as a foreign merger under subsection 87(8.1). TEI applauds the revisions and clarifications, but suggests that the proposed legislation may not fully address a horizontal absorptive merger where a brother company is absorbed by its sister. We recommend the following changes to proposed subsection 95(4.2) and current subsection 87(8.1) (with the recommended changes noted in italics):

Proposed subsection 95(4.2):

(c) all properties of the survivor corporation *and the predecessor corporations* immediately before the merger or combination that are properties of the survivor corporation immediately after the merger or combination are deemed to become properties of the survivor corporation as a consequence of the merger or combination;

(d) all liabilities of the survivor corporation *and the predecessor corporations* immediately before the merger or combination that are liabilities of the survivor corporation immediately after the merger or combination are deemed to become liabilities of the survivor corporation as a consequence of the merger or combination; . . .

Current subsection 87(8.1):

(c) all or substantially all of the shares of the capital stock of the predecessor foreign corporations (except any shares or options owned by any predecessor foreign corporation) *either cease to exist because of the merger or combination or* are exchanged for or become, because of the merger or combination, . . .

Surplus Reclassification Rule

Proposed Regulation 5907(2.02) introduces a new anti-avoidance rule that reclassifies exempt earnings as taxable earnings for surplus computation purposes where the earnings arise from a transaction or series of transactions that is an “avoidance transaction” under subsection 245(3), or would be an avoidance transaction if the recognition of the earnings were regarded as a “tax benefit” under subsection 245(1). The Explanatory Notes state that —

This new rule directly incorporates the standards of the “general anti-avoidance rule” in section 245 rather than creating its own set of avoidance standards. Essentially, any “avoidance transaction” that results in an increase in “exempt earnings” will be considered abusive and will be reclassified to “taxable earnings”.⁷

TEI recognizes that an anti-avoidance rule may be necessary to curb tax-motivated transactions designed to increase a foreign affiliate’s exempt earnings. We believe, moreover, that the GAAR standard in section 245 is the appropriate touchstone for evaluating the *bona fides* of a transaction. Regrettably, however, the proposed legislation creates a *per se* rule that an avoidance transaction is abusive rather than testing in the particular circumstances whether the transaction is a misuse or abuse of the Act. We believe the rule in proposed Regulation 5907(2.02) is overbroad and should be circumscribed by a requirement similar to GAAR to test an avoidance transaction as a misuse or abuse of the Act. At a minimum, proposed Regulation 5907(2.02) should not apply to transactions that fall within the “packaging” rule in proposed Regulation 5907(2.01). Similarly, an exception to the *per se* anti-avoidance rule should be added to proposed Regulation 5907(5.1) for rollover transactions.

Returns of Capital

TEI welcomes the proposed simplification of the rules governing the characterization of distributions and the source of surplus from which a foreign affiliate’s distribution is considered paid. We also welcome the election permitting taxpayers to change the surplus-ordering rules so that dividends are, for example, deemed paid from pre-acquisition surplus rather than taxable or hybrid surplus. In light of the policy objectives underlying the surplus-ordering rules as well as the election afforded to taxpayers, we recommend permitting taxpayers to make late-filed elections in respect of distributions from pre-acquisition surplus. Adding such a provision would permit taxpayers to maintain the intended characterization of a distribution where, for example, a tax audit adjustment made subsequent to the distribution for the year of or year preceding the distribution results in a reclassification of surplus from exempt to taxable.

Conclusion

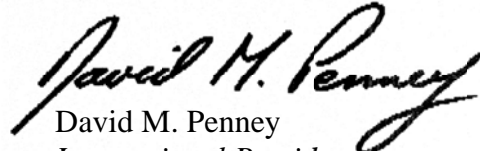
TEI’s comments were prepared under the aegis of the Institute’s Canadian Income Tax Committee, whose chair is Carmine A. Arcari. If you should have any questions about the comments or recommendations in the submission, please do not hesitate to call Mr. Arcari at

⁷ *Explanatory Notes - Foreign Affiliate Amendments*, Department of Finance, Canada (August 19, 2011), at page 80.

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Respectfully submitted,

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