TAX EXECUTIVES INSTITUTE, INC.

on

PENDING CANADIAN INCOME TAX ISSUES

Submitted to

THE DEPARTMENT OF FINANCE

NOVEMBER 16, 2016

Tax Executives Institute welcomes the opportunity to present the following comments and questions on income tax issues, which will be discussed with representatives of the Department of Finance during the November 16, 2016 liaison meeting. If you have any questions about the agenda in advance of the meeting, please do not hesitate to call Steve Perron, TEI's Vice President for Canadian Affairs, at 514.841.3412, or Paul Magrath, Chair of TEI's Canadian Income Tax Committee, at 905.804.4930.

A. Legislative Update and Tax Policy Discussion

1. *Legislative Priorities*

TEI invites an update on the Department of Finance's legislative priorities over the coming months.

2. *BEPS Matters*

TEI invites an update and discussion on the status of the BEPS project from a Canadian perspective. Topics raised by members include the following:

a. In an OECD Tax Talks presentation dated September 22, 2016, the OECD provided an update on the progress of the multilateral instrument, BEPS action item 15. We are interested in Canada's perspective. What is the timing and outlook for the multilateral instrument? What might it look like? How quickly would substantive changes to existing treaties come into force? Is Canada thinking of reservations or specific commentary to specific aspects of the broad treaty changes contemplated by the multilateral instrument?

b. We have concerns about the proposed revised definition of permanent establishment, BEPS action item 7. In particular, we are concerned about expanding the definition of permanent establishment to include the location of a person who "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification."

Some Canadian resource exporters are concerned that treaty partners may rely on this definition of permanent establishment to attribute profits from Canadian production of natural resources to themselves as consumer countries. From another perspective, some of our members are concerned that their Canadian head-office screening of significant foreign-customer contracts might be viewed by the Canadian government as Canadian permanent establishments of their foreign businesses. Both situations create concerns about increased tax-return obligations as well as disputes between treaty partners over the allocation of profits between Canada and other jurisdictions.

We also note OECD's work on BEPS action item 7 and applaud the pragmatism in the conclusion at paragraph 39 of that work, which accepts the notion that a dependent-agent permanent establishment with limited functionality ought not to attract a profit allocation. We welcome a discussion of the Department's views and thoughts in this area.

3. *Carbon Taxation*

We are attentively following provincial, federal, and global developments surrounding the Paris Agreements and carbon taxation. We are interested in the Department's views on how this might unfold in Canada, with particular reference to taxpayer concerns of the potentially high costs of compliance in a fragmented system.

4. *Country-by-Country Reporting and Privacy*

The Department recently released draft legislation on country-by-country reporting for Canadian multinationals. Throughout the BEPS process, assurances were given that all information exchanged through country-by-country reporting would be subject to confidentiality rules and other safeguards provided for under applicable tax treaties and domestic law. Strictly speaking, we understand this is still true, as taxpayer-prepared country-by-country reporting materials will be shared only with treaty partners and, in that context, subject to confidentiality rules and other safeguards. At the same time, however, Canada's treaty partners are legislating the public disclosure of subsets of the same or similar information. This is disconcerting to us, especially because it might create situations in which governments might be seen as complying with the letter but not the spirit of their own international cooperation. We welcome the Department's perspective on this matter.

5. *Grace Period for Controlled Foreign Companies*

The United Kingdom has rules that provide UK corporations with a 12-month grace period for becoming fully compliant with controlled-foreign-company legislation on acquiring foreign corporations. If a UK taxpayer is not fully compliant within this 12-month period, the attributable CFC income applies from the date of the acquisition. Would the Department consider a similar rule for Canadian taxpayers?

B. Carryover Matters

1. *Prohibited Investments*

The prohibited investment rules for Registered Retirement Savings Plans ("RRSP"), Registered Retirement Income Funds ("RRIF"), and Tax Free Savings Accounts ("TFSA") have been extended to retirement compensation arrangements ("RCA"). Effective March 23, 2011, Section 207.01(1) was amended to provide an excluded property exemption from the concept of prohibited investments for RRSPs, RRIFs, and TFSAs; however, it was not extended to RCAs. Would the Department consider an amendment to conform the RCA prohibited investment-advantage rules to the amended rules for RRSPs, RRIFs and TFSAs with an effective date of March 29, 2012 (the date on which the prohibited investment rules were extended to RCAs)?

We asked a variation of this question in 2013, and the Department responded that it was prepared to consider this matter because it would generally make sense to have consistency among deferred plans. However, the Department indicated that its then-current workload was significant and needed to prioritize its efforts.

2. *Treaty Residence – Subsection 250(5)*

Is the Department prepared to consider amending subsection 250(5) so that, where a corporation is regarded as a resident only in another jurisdiction under a tax treaty, that corporation is deemed by reason of its place of incorporation (i) not to be resident in Canada and (ii) to be resident in that jurisdiction for all purposes of the Income Tax Act and regulations?

We asked the Department in 2013 about the interaction between being a tax treaty non-resident of Canada, subsection 250(5), and various surplus calculation rules. The Department expressed sympathy with the core point but noted that it was awaiting "further global developments in the area" before making any changes. That point was, if a foreign affiliate is resident in a foreign country under the treaty with that country, it should follow that the foreign affiliate is a resident of the treaty jurisdiction and not a resident of Canada for all purposes, including all foreign-affiliate rules and surplus calculations. Subsection 250(5) currently provides a narrow rule that is applicable only to dual-resident companies that are resident in Canada under Canadian principles but are deemed resident with another country under a tax treaty with the other country. In this circumstance, the company is deemed not to be a resident of Canada but is also not deemed to be a resident of the treaty country. Furthermore, outside a dual-resident context, it is possible for a non-resident corporation to be viewed as a resident of a treaty country under treaty principles but not a resident of the treaty country under Canadian common-law principles.

C. **New Matters**

1. *Qualifying Environmental Trust*

a. Background

Provincial and territorial environmental regulations commonly impose security requirements for reclamation obligations on taxpayers engaged in mining and other activities to ensure sufficient financial resources are available for reclamation and remediation of lands, water, and property affected by the taxpayers' activities. To pay for these reclamation costs, taxpayers must post financial security in the forms of cash, bonds, or other forms acceptable to the province or territory. These amounts may be very large, often in the billions of dollars, and are generally due in the near future.

The Income Tax Act provides taxpayers with a Qualifying Environmental Trust ("QET") regime for funding future reclamation costs of certain large-scale reclamation obligations, including for mines and pipelines.

b. Qualifying Site

Under the Act, a QET is a trust maintained for the sole purpose of funding the reclamation of a qualifying site that also meets certain other tests. Subsection 211.6(1) defines a "qualifying site" as a site in Canada primarily used for, among other things, the operation of a mine. This narrow focus gives rise to interpretive issues that could put what would be a QET outside this definition despite a project being a resource project with substantial regulatory requirements for setting aside funds to secure the property's future reclamation.

To minimize the uncertainties, anomalies, and the narrow scope of the current definition of "qualifying site," would the Department consider generalizing the definition to include any site in Canada where all or partial pre-funding for the reclamation of the site is subject to regulation by a governmental authority?

c. Meaning of "Mine"

If the Department does not accept that regulatory requirements should form the basis for "qualifying site," might it alternatively expand the definition? For example, it is unclear if an oil sands upgrader (essentially a refinery to convert bitumen to synthetic crude oil) is part of a mine within the definition even though upgraders near mine sites are included in reclamation pre-funding under the Mine Financial Security Program in Alberta.

The CRA has provided some helpful guidance but that guidance still leaves uncertainty. In CRA Views 2012-0463871R3, the CRA considered the definition of a "qualifying site" and indicated the taxpayer's site that had to be remediated under provincial legislation met the definition of a "qualifying site" for QET purposes under Section 211.6. The ruling defined the taxpayer's "Site" as various specified mines and their "Facilities, and any land, water or watercourse used or disturbed by the construction or operation of [those mines]." The "Facilities" were defined as "the mines, mills, brine ponds, tailing management areas and any other fixtures, chattels or improvements located on the Sites."

Further, in CRA Views 2012-0463621R3, the CRA stated, "The purpose behind the QET is to provide a taxpayer a method of funding future reclamation costs with respect to a mine. To define the mine site narrowly, such that only the shaft is included does not support the policy of a QET. Thus for QET purposes, the area included in the 'operation of a mine' includes more than just the shaft and immediate workings."

While the CRA took a somewhat expansive view of a qualifying site, consistent with the CRA's understanding of the purpose of the legislation, and that approach appears to extend beyond the mine body and immediate workings, the current definition under subsection 211.6(1) does not clearly delineate what mine-related assets or infrastructure are included in the operation of a mine.

Given the magnitude of taxpayers' pre-funding reclamation obligations and the uncertainty of what mine-related assets and infrastructure may be included in a qualifying site, would the Department consider amending the definition of a "qualifying site" to include all mine-related assets and infrastructure for which the taxpayer must post security under a provincial reclamation security program?

d. Excluded Trust / Prohibited Investments

The definition of "excluded trust" in subsection 211.6(1) excludes a trust that was not a QET at any previous time during its existence. Therefore a trust that acquires or holds a prohibited investment at any time will be an excluded trust and permanently disqualified from being a QET. This seems to be a very punitive result given that in some circumstances the acquisition of the "prohibited investment" may be temporary or inadvertent, and in any event may be outside a taxpayer's control, as the QET rules expressly require that the investment function be undertaken by a trustee that is independent from the taxpayer. In addition, in circumstances where a government agency is a beneficiary under the QET, financial instruments issued by that government may be prohibited investments. We are not aware of a public policy reason to include government-issued financial instruments within the meaning of prohibited investments.

Would the Department consider amending the QET legislation to (i) eliminate from inclusion in prohibited investments financial instruments issued by a government or government agency and (ii) use a reasonable method other than permanent tainting to discourage the trust from making prohibited investments?

2. Foreign Exchange Losses on Debt Repayment

This question asks about the possibility of allowing net capital losses from the repayment of long-term debt to off-set against ordinary operating income when adverse selection is not practical under the circumstances of the losses.

Long-term borrowing by non-financial corporate taxpayers is typically on capital accounts. Often for commercial reasons, such as the depth and liquidity of U.S. currency bond markets, taxpayers make long-term borrowings in U.S. currency. When Canadian-currency taxpayers repay these loans, they realize either a foreign-exchange gain, half of which is included in income and taxed, or a foreign-exchange loss, half of which will be a net capital loss. In the latter situation, that loss will only be tax-effected with a taxable capital gain in an off-setting amount in the carryforward or carryback period. For non-financial businesses, where funds are invested in inventory and depreciating capital assets, realized net capital losses on debt repayments have a good chance of being stranded. These capital losses represent real costs that may not ever be recognized for tax purposes.

The tax-policy justification for restricting capital-loss deductions is the potential for "adverse selection" associated with the taxation of capital gains and losses on a realization basis rather than an accrual basis.[1] That is, the limitation might mitigate the incentive that would otherwise exist to recognize losses while leaving accrued gains unrealized. We observe that, in the context of debt repayments, selection bias does not exist. Rather, the timing of the realization of the gain or loss on the debt is dictated by the initial debt contract. Accordingly, in the absence of a potential for adverse selection, the source restriction is not justified.

Will the Department consider allowing net capital losses from the repayment of long-term debt to off-set against ordinary operating income? For clarity, the suggestion is not that these losses be treated on income accounts but, rather, the one-half net capital loss be deductible against income from other sources.

3. *Loss Limitation on Foreign Affiliate Shares*

This question asks about the possibility of the Department implementing the Joint Committee recommendation of October 2011 that subsection 40(3.4) be amended to exclude certain losses. We refer you to submissions made by both Tax Executives Institute and the CICA-CBA Joint Committee on Taxation on October 19, 2011 in response to the legislative proposals made by the Department on August 19, 2011. Specifically, we refer you to the anomaly pointed out by the Joint Committee on the operation of subsections 93(2.1) and its interaction with subsection 40(3.6). The Joint Committee recommended that "subsection 40(3.4) be amended to exclude from its application losses that are allowed under paragraphs 93(2.01)(b), 93(2.11)(b), 93(2.21)(b) and 93(2.31)(b) and that subsection 40(3.6) be amended to exclude from its application losses that are allowed under paragraph 93(2.01)(b) or 93(2.11)(b)." Might the Department amend these subsections and paragraphs as such?

The rules allow recognition of a loss arising from a disposition of a foreign-affiliate share, or a partnership interest that holds a foreign-affiliate share, to the extent such loss may reasonably be attributable to a foreign-exchange fluctuation and the taxpayer realizes a corresponding foreign-exchange gain on a debt or hedge obligation incurred when the share was acquired. Such losses might otherwise be reduced or denied to the extent of exempt dividends received on the share.

As we understand it, the policy intent is to permit hedges to be tax effective. That is, while the general rule is that capital losses realized on dispositions of shares of foreign affiliates

[1] TAX POLICY IN CANADA at 6:8 (CTF 2012).

should be reduced by the exempt dividends received on the share, that rule is set aside when dealing with a foreign-exchange loss that corresponds to a foreign-exchange gain realized on a debt or hedge obligation that was set up when the share was acquired. However, this policy intent is frustrated by what might be a technical anomaly in the rules. In circumstances where a taxpayer deals with shares of its own foreign affiliate, the stop-loss rule in subsection 40(3.6) will often deny the loss (and add the denied loss to the adjusted cost base of other shares in the capital of the foreign affiliate). For the relieving rules in section 93 to work, there must initially be an "allowable capital loss." Because the strict wording of subsection 40(3.6) applies to eliminate the relevant capital loss to nil, there would be no allowable capital loss when the subsection applies and the relief for hedging rules in section 93 cannot apply.

Might subsection 40(3.4) be amended to exclude certain losses as discussed above?

4. *Foreign Affiliate Dumping Rules*

The Foreign Affiliate Dumping ("FAD") rules are designed to deter Canadian subsidiaries of foreign-based multinational groups from making investments in non-resident corporations that are or become foreign affiliates of the Canadian subsidiary when these investments can inappropriately erode the Canadian tax base. Targeted investments include purchases of and subscriptions for shares of a foreign affiliate, capital contributions and loans to a foreign affiliate ("FA"), and acquisitions of shares of a Canadian company, the assets of which are substantially FA shares. This is to ask for the Department's views on ambiguities that arise in the following situations:

> Situation #1 – When amounts are temporarily owed as a result of the redemption of shares;
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> Situation #2 – When amounts are temporarily owed that arise in the course of a winding up;
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> Situation #3 – In the case of a financial institution, when amounts are owed that arise in the ordinary course of a Canadian-resident corporation's ("CRIC") lending business when restructuring a defaulting loan; or
>
> Situation #4 – When shares of a debtor's non-Canadian subsidiary are acquired by a financial institution when seizing security while dealing with a defaulting loan.

Section 212.3(10) includes in the definition of "investment" by a CRIC in a subject corporation the following:

(a) an acquisition of shares of the capital stock of the subject corporation by the CRIC;

…

(c) a transaction under which an amount becomes owing by the subject corporation to the CRIC, other than an amount owing

(i) that arises in the ordinary course of the business of the CRIC and that is repaid, other than as part of a series of loans or other transactions and repayments, within 180 days after the day on which the amount becomes owing,

(ii) that is a pertinent loan or indebtedness immediately after the time of the transaction, or

(iii) because a dividend has been declared, but not yet paid, by the subject corporation;

Based on this current wording, it is not clear whether the exemption from the definition of "investment" in paragraph 212.3(10)(c)(i) is available for Situations 1 and 2, above, as it is not clear what is within the scope of the CRIC's "ordinary course of business." One view is that the redemption of affiliate shares, the winding up of affiliates and, in the context of a financial institution, debt restructurings are all ordinary-course-of-business exemptions so that the 180-day grace period applies. Another view is that Situations 1 and 2 are less business-oriented, more capital-oriented, more unusual, and therefore not eligible for the exemption.

Furthermore, the grace period creates another problem. The rule requires repayment within 180 days after the day on which an amount becomes owing. This is, simply speaking, not always enough time, particularly in the context of a winding up or a significant debt restructuring.

For Situation 4 above, shares of a debtor's non-Canadian subsidiary acquired by a financial institution as a result of seizing a security while dealing with a defaulting loan would also be caught by the FAD rules, as there is no specific exemption.

We invite the Department's comments on the intended scope of the "ordinary course of business" exemption, on the possibility of extending the 180-day grace period, and the application of this Code section to a debt restructuring (or more) and possibly extending the exemption to shares and other assets of a non-Canadian company acquired when seizing security while dealing with a defaulting loan.

5. *Paragraph 55(3.01) and Partnerships*

As you are well aware, subsection 55(2) is an anti-avoidance provision generally designed to prevent an inappropriate reduction of a capital gain through deductible intercorporate dividends, subject to certain important exceptions. This topic addresses a seemingly unintended consequence of section 55 as it applies to multi-tiered partnerships and suggests corrective statutory language.

As a result of recent amendments to subsection 55(2), any proposed intercorporate dividend must be reviewed with great care to ensure it does not trigger inadvertent results. While "safe income" calculations may become the new norm, taxpayers may also be in a position to benefit from the protections of subsection 55(3), particularly in a related group setting where paragraph 55(3)(a) can apply. In general terms, paragraph 55(3)(a) provides an exemption from the operation of subsection 55(2) for certain dividends deemed to be paid as part of a series of transactions or events where there is no disposition of property to, or significant increase in the total direct interest of, an unrelated person, as defined in paragraph 55(3.01)(a). For purposes of section 55, the concept of an unrelated person can have different meanings, and lead to anomalous results, depending on the type of entity used in certain wholly-owned related party structures. Compare the following scenarios:

Group #1 – Consider a group of related corporations whereby the top-tier corporation ("Parentco") owns 100% of the shares of a first-tier subsidiary corporation ("First Co"), which in turn owns 100% of the shares of a second-tier subsidiary corporation ("Second Co"). In this structure, Second Co transfers property to a wholly-owned subsidiary ("Third Co") on a tax-deferred basis and, in the event of a subsequent deemed dividend by Third Co that forms part of the series of transactions that included the property transfer, the parties may be able to rely on paragraph 55(3)(a).

Group #2 – Consider a similar group where partnerships exist below Parentco, such that the first-tier entity below Parentco is a partnership ("First Partnership"), the partners of which are Parentco and its wholly-owned subsidiary corporation ("Sub 1 Co"), and the second-tier entity below First Partnership is another partnership ("Second Partnership"), the partners of which are First Partnership and its wholly-owned subsidiary corporation ("Sub 2 Co"). Similar to that described above, assume that Second Partnership transfers property to a wholly-owned subsidiary, also referred to here as Third Co.

Paragraph 55(3.01)(a) provides that a partnership, every member of which is related to the dividend recipient, is not an unrelated person in respect of such dividend recipient for the purposes of paragraph 55(3)(a). However, there is an anomaly in this rule regarding "tiered partnerships." Under Group #2 described above, First Partnership is not an unrelated person in respect of any of the dividend recipients by virtue of paragraph 55(3.01)(a), because each of its members is related to the relevant dividend recipient (or is the dividend recipient). However, while First Partnership is not an unrelated person per paragraph 55(3.01)(a), it is not actually related to any of the dividend recipients because there is no provision of the Income Tax Act that deems a partnership to be related to a person for the purposes of paragraph 55(3)(a). Thus, pursuant to paragraph 55(3.01(a), Second Partnership is an unrelated person in respect of each of the dividend recipients because one of its members (First Partnership) is not related to the relevant dividend recipient. As a result, subparagraph 55(3)(a)(i) would apply to any dividends deemed to be received as part of the relevant series because there would be a significant increase in the share interest of a corporation (Third Co) by an unrelated person (Second Partnership).

This apparent anomaly applies to any partnership that has a partnership as one of its members, such that a third-tier or fourth-tier partnership would be an unrelated person in respect of the relevant dividend recipient even if all of the ultimate corporate members of each of the "tiered partnerships" were related to the dividend recipient. This result would also apply to a tax-deferred transfer of property to a second-tier partnership as it would be a transfer to an unrelated person for less than fair-market value for the purpose of section 55.

As indicated above, we believe this is an anomalous result that was unintended and that the recent changes to section 55 have made this more critical to correct. We note that, in recent years, the Department has addressed the issue of tiered partnerships elsewhere in the Income Tax Act, notably subsection 15(2.14) and paragraph 212.3(25)(f) as well as subparagraph 1100(16)(b)(ii) of the Income Tax Regulations. Accordingly, we believe an appropriate amendment could be made as follows:

> 55(3.01) For the purposes of paragraph (3)(a),
>
> (a) an unrelated person means a person (other than the dividend recipient) to whom the dividend recipient is not related or a partnership any member of which (other than the dividend recipient) is not related to the dividend recipient, <u>and for the purposes of this paragraph, a partnership every member of which (other than the dividend recipient) is related to the dividend recipient shall be deemed to be related to the dividend recipient</u>

This proposed amendment should result in the deeming rule applying to partnerships that are members of second-tier and further lower-tier partnerships. We believe that result is entirely consistent with the policy, and "related party" nature, of the exception contained in paragraph 55(3)(a). There does not appear to be any policy rationale to distinguish between a first-tier partnership and a lower-tier partnership in a multi-tiered partnership structure where, looking through each of the relevant partnerships to its ultimate corporate members, each such member of a particular partnership is a person related to the relevant dividend recipient. Likewise, there does not appear to be any policy rationale to distinguish between lower-tier corporations and lower-tier partnerships within a related group.

a. Does the Department agree that the result noted above under the current wording of subsection 55(3.01) is unintended and inconsistent with the policy behind paragraph 55(3)(a)?

b. Would the Department agree to recommend the amendment of paragraph 55(3.01)(a) as proposed above?

c. If so, would the Department agree to recommend that the proposed amendment to paragraph 55(3.01)(a) be made effective from the date that paragraph 55(3.01)(a) was originally made effective?

6. *Debt Parking and Foreign Exchange Gains and the Budget Measures*

a. Background

Canadian multinationals conduct their businesses in both Canada and abroad. To finance the acquisitions of foreign affiliates, they generally issue foreign-denominated debt. The selection of a stated maturity of that debt is always based on various factors, principally the issuer's current maturity profile of its existing outstanding debts as well as the pricing and coupon associated with the new issuance, which is based on the various maturities. The longer the stated maturities, the higher the interest rates are. Canadian multinationals generally try to achieve and maintain a staggered maturities on their debt portfolios when choosing a stated maturity for a particular debt issuance, compatible with market conditions.

Issuing and maintaining foreign-denominated debt provides Canadian multinationals with a natural hedge and symmetry to their foreign assets in the context of on-going currency fluctuations compared to the Canadian dollar. Issuing debt with a gain or loss that cancels out the corresponding loss or gain on foreign assets is a simple method of reducing vulnerability to foreign-exchange fluctuations. If the foreign currency decreases compared to the Canadian dollar, the foreign-exchange gain on foreign-denominated debt obligations is counterbalanced by a foreign-exchange loss on the foreign assets.

A natural hedge such as this one, unlike other types of hedges, does not require the use of sophisticated financial products such as forwards or derivatives. Most hedges are imperfect and do not eliminate the foreign-exchange fluctuation risk entirely but can significantly alleviate its impact. For Canadian multinationals, matching foreign-denominated debt obligations with foreign assets mitigates, on an ongoing basis, the volatility and unpredictability that currency fluctuation can cause on the Canadian multinational's financial position, results, and share value.

Canadian multinationals routinely issue, repay, and reissue foreign-denominated debts in the foreign institutional public debt market with stated maturities spread out up to 50 years. As a result of these ongoing issuances and repayments of foreign-denominated debts, Canadian multinationals continually maintain significant foreign-denominated debt obligations maturing at different times. Proceeds from reissuance of foreign-denominated debts are generally used to repay maturing foreign-denominated debts.

When debts are nearing maturity at the same time as a significant downturn in the value of the foreign currency compared to the Canadian dollar, thus causing a decrease in the Canadian-dollar value of the foreign hedge assets, the debt repayment would cause the Canadian multinational to realize a foreign-exchange gain for tax purposes. This would result entirely because of the volatile foreign-currency fluctuation, even though any such gain would, in economic terms, be counterbalanced with a foreign-exchange loss in the foreign assets.

This capital-gains realization on debt repayment for tax purposes is arguably an unreasonable outcome considering that gain did not provide the Canadian multinational with an economic benefit; that benefit was concurrent with a large unrealized decrease in the Canadian-dollar value of the Canadian multinational's foreign assets. It is simply the result of an artificial play of the currency volatility causing an unfair distortion to the Canadian multinational, unaccompanied by equivalent economic realizations, and therefore creating a significant impact to cash flow.

Prior to the 2016 Budget, the extension of maturing debts in accordance with foreign corporate laws was a way to mitigate this unreasonable outcome. However, this is no longer possible with the introduction of the foreign denominated debt-parking rules. Canadian multinationals are now required to realize the foreign-exchange gain, even if there is no economic benefit associated with this gain. Canadian multinationals generally do not intend to dispose of the long-term foreign asset acquired at the time of the issuance of the foreign denominated debt.

b. Questions

Regarding the situation described above, as no economic benefit is realized by a Canadian multinational,

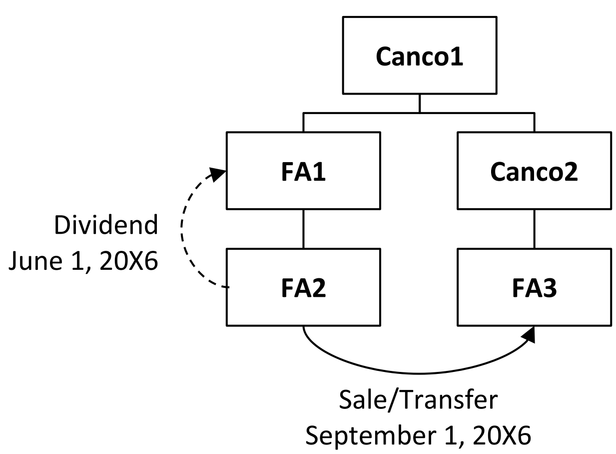
i. Would the Department consider introducing a rollover provision where the foreign-exchange gain of a maturing foreign-denominated debt would be rolled to a newly issued foreign-denominated debt? This provision would be similar to an exchange-of-property rollover pursuant to subsection 44(1) but in the context of foreign-denominated debt.

ii. Alternatively, would the Department consider introducing a provision in which the foreign-exchange gain realized at the time of repayment of the foreign-denominated debt would reduce the adjusted cost base of the foreign asset acquired at the time the foreign-denominated debt was issued instead of being taxed at the time the debt is disposed?

7. *Interpretation of the 90-day rule in Reg. 5901(2)(a)*

This question requests clarification on the application of Reg. 5901(2)(a) in similar fact patterns that creates ambiguity under current interpretation. Consider the following two scenarios:

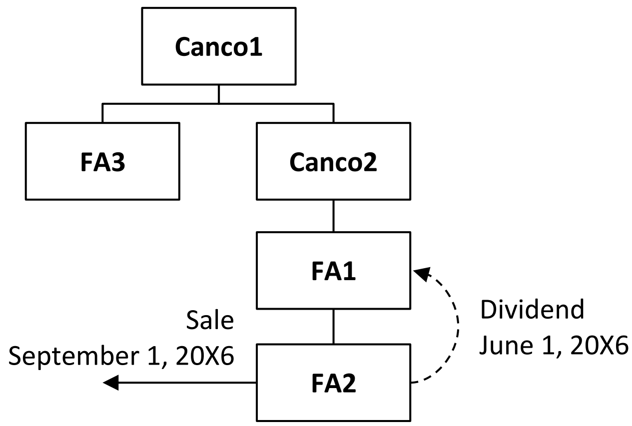
a. Scenario A



i. FA2 is a non-resident corporation and a wholly owned subsidiary of FA1.
ii. FA2 carries on an active business in a Tax Information Exchange Agreement jurisdiction.

iii. FA1 is a non-resident corporation and a wholly owned subsidiary of Canco1, a corporation resident in Canada.
iv. FA1 is a holding company resident in a Designated Treaty Country ("DTC").
v. FA1 and FA2 are both "foreign affiliates" of Canco1.
vi. FA1 and FA2 both have taxation years ending December 31, 20X5.
vii. The shares of FA2 qualify as excluded property.
viii. FA3 is a wholly owned foreign subsidiary of Canco2 and resident in a DTC.
ix. Canco2 is a corporation resident in Canada and a wholly owned subsidiary of Canco1.
x. On June 1, 20X6 (more than 90 days after the start of its taxation year), FA2 pays a whole dividend to FA1. FA2 does not have sufficient surplus at the particular time for the whole dividend to be considered paid out of surplus such that, absent the 90-day rule in Reg. 5901(2)(a), a portion of the whole dividend would be deemed to be paid out of FA2's pre-acquisition surplus. However, FA2 will have sufficient exempt earnings for the taxation year ending December 31, 20X6 such that the portion of the whole dividend deemed to be paid out of FA2's pre-acquisition surplus would instead be deemed to be a separate whole dividend paid out of the exempt surplus as a result of the application of Reg. 5901(2)(a).
xi. On September 1, 20X6, FA2 is sold by FA1 to FA3 for fair-market value cash consideration that exceeds FA1's adjusted cost base of the FA2 shares (before any adjustment for pre-acquisition dividends) in the course of an internal reorganisation.
xii. FA2 remains, at all relevant times, a foreign affiliate of Canco1.

b. Scenario B



The facts are the same as those in Scenario A, except that:

i. FA1 and FA2 are both "foreign affiliates" of Canco2.

ii. FA3 is a wholly owned foreign subsidiary of Canco1 and resident in a DTC.

iii. On June 1, 20X6 (more than 90 days after the start of its taxation year), FA2 pays a whole dividend to FA1. FA2 does not have sufficient surplus at the particular time for the whole dividend to be considered paid out of surplus such that, absent access to the 90-day rule in Reg. 5901(2)(a), a portion of the whole dividend would be deemed to be paid out of FA2's pre-acquisition surplus. However, FA2 will have sufficient exempt earnings for the taxation year ending December 31, 20X6 so that the portion of the whole dividend deemed to be paid out of FA2's pre-acquisition surplus would instead be deemed to be a separate whole dividend paid out of the exempt surplus to the extent Reg. 5901(2)(a) were to apply.

iv. On September 1, 20X6, FA2 is sold by FA1 to FA3 for fair-market value cash consideration that exceeds FA1's adjusted costs base of the FA2 shares (before any adjustment for pre-acquisition dividends) in the course of an internal reorganisation.

v. FA2 ceases to be a foreign affiliate of Canco2.

c. Question

In Scenario A, all of the requirements in Reg. 5901(2)(a) are met so that the portion of the whole dividend deemed to be paid out of FA2's pre-acquisition surplus on June 1, 20X6 should be subject to the 90-day rule. FA2 will be deemed to have paid a separate whole dividend out of its exempt surplus immediately after the end of its taxation year ending December 31, 20X6.

In addition, FA1 will include in its exempt surplus, on June 1, 20X6, the separate whole dividend received from FA2.

However, it is not clear how the 90-day rule in Reg. 5901(2)(a) applies in Scenario B. Based on one possible interpretation, not all of the requirements in Reg. 5901(2)(a) appear to be met, as FA2 is not a foreign affiliate of Canco2 at all relevant times. This seems anomalous in a situation where, at all relevant times, FA2 is a member of the Canco1 group, as it would potentially give rise to hybrid surplus in FA1 on the sale of the FA2 shares and exempt surplus in FA2 without the corresponding funds to be able to distribute such surplus to FA3.

Would the Department consider a legislative amendment, perhaps by amending paragraph 95(2)(n), in order to clarify the application of Reg. 5901(2)(a) in situations such as Scenario B?

8. *T4 Reporting and Regulation 102*

Form RC473, Non-Resident Employer Certification and related legislative changes ("the Reg 102 Certification regime") came into effect on January 1, 2016 so as to increase taxpayers' efficient compliance with the so-called "Business Traveler" rules in Regulation 102 ("Reg 102"). These improvements were originally proposed as part of the 2015 federal budget in response to significant feedback from the tax community including TEI. Generally the new rules allow qualifying non-resident employers to be certified and thereby relieved of certain Canadian tax withholding requirements to qualifying non-resident employees.

Pursuant to these rules, a "qualifying non-resident employee" is one who, among other things, has fewer than 45 work days in Canada in a calendar year or is present in Canada for any purpose for fewer than 90 days in any 12-month period ("the 45/90 day test"). Additionally, where a "qualifying non-resident employee" earns less than $10,000 of Canadian-sourced compensation, the requirement to report such remuneration on a T4 is waived. In many cases this will also alleviate the need to obtain a Canadian taxpayer identification number for the qualifying non-resident employee.

These rules show a clear disconnect between (i) the alleviation of the withholding and remittance requirement and (ii) the exemption from T4 reporting. In particular, pursuant to paragraph 200(1.1)(b) of the Regulations, a qualifying non-resident employer would have to obtain a TIN and prepare T4s annually for all qualifying non-resident employees who earned more than $10,000 but were otherwise exempt from all withholding and remittance requirements under the 45/90 day test. This reporting requirement, along with associated TIN applications, creates a significant administrative burden on both taxpayers and the CRA for employees who should not have tax withheld from their pay.

Unlike the 45/90 day test, which is a relatively straightforward threshold to track and monitor, the current $10,000 T4 reporting threshold requires an analysis of each qualifying non-resident employee's total remuneration, which is not just salary; it includes every component of remuneration, including commissions, bonuses, pension, and related registered plan benefits. Ascertaining that type of information for each qualifying non-resident employee is a time-consuming task. Because the obligations of a qualifying non-resident employer also include making its books and records available, in Canada, on request for inspection by CRA for purposes of administering the Reg 102 Certification regime, there is significant potential for far-reaching audit requests. Furthermore, this requirement is of questionable value considering a qualifying non-resident employee must not be liable for tax under Part I of the Income Tax Act because of a tax treaty. Such a qualifying non-resident employer must evaluate and document its expectation of that status as part of its certification obligations anyway. For these reasons, TEI believes that the $10,000 T4 reporting threshold places an inordinate and largely unnecessary burden on qualifying non-resident employers, given the aim of the Reg 102 Certification regime.

Consistent with TEI representations made to the Department prior to Budget 2015, and prior to the related amendment of subsection 200(1.1) of the Regulations, we propose that the Reg 102 Certification regime be revisited to align the relief from withholding tax with the exemption from T4 reporting under the 45/90 day test. Specifically, would the Department revise subsection 200(1.1) of the Regulations as follows?:

200(1.1) Subsection (1) does not apply in respect of

(a) an annuity payment in respect of an interest in an annuity contract to which subsection 201(5) applies; or

(b) an amount paid by a qualifying non-resident employer to a qualifying non-resident employee that is exempted under subparagraph 153(1)(a)(ii) of the Act ~~if the employer, after reasonable inquiry, has no reason to believe that the employee's total amount of taxable income earned in Canada under Part I of the Act during the calendar year that includes the time of this payment (including an amount described in paragraph 110(1)(f) of the Act) is more than $10,000~~.

We note that this amendment would be revenue neutral to the amount of withholding tax collected, and would significantly reduce the administrative costs to both taxpayers and the CRA. TEI believes that this will also encourage additional participants in the Reg. 102

Certification regime. If the Department is unwilling to make this proposed revision, would it please explain the rational for the existence of the $10,000 T4 reporting threshold currently contained in paragraph 200(1.1)(b) of the Regulations?

D. Conclusion

Tax Executives Institute appreciates the opportunity to present its comments on these pending income tax issues, and we look forward to discussing our views with the Department of Finance during the November 16, 2016 liaison meeting.

Respectfully submitted,
Tax Executives Institute, Inc.

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