Comments

of

TAX EXECUTIVES INSTITUTE, INC.

on

PENDING CANADIAN INCOME TAX ISSUES

Submitted to

THE DEPARTMENT OF FINANCE

DECEMBER 4, 2013

Tax Executives Institute welcomes the opportunity to present the following comments on income tax issues, which will be discussed with representatives of the Department of Finance during TEI's December 4, 2013, liaison meeting. If you have any questions about these comments, please do not hesitate to call either Shiraz J. Nazerali, TEI's Vice President for Canadian Affairs, at 403.213.8125, or, Bonnie Dawe, Chair of the Institute's Canadian Income Tax Committee, at 604.331.4864.

Background

Tax Executives Institute is the preeminent professional organization of in-house business executives who are responsible — in an executive, administrative, or managerial capacity — for the tax affairs of the corporations and other businesses by which they are employed. TEI's nearly 7,000 members represent more than 3,000 of the leading corporations in Canada, the United States, Europe, and Asia.

Canadians make up approximately 10 percent of TEI's membership, with our Canadian members belonging to chapters in Montreal, Toronto, Calgary, and Vancouver, which together make up one of our nine geographic regions. In addition, a substantial number of our U.S., European, and Asian members work for companies with significant Canadian operations. In sum, TEI's membership includes representatives from most major industries, including manufacturing, distributing, wholesaling, and retailing; real estate; transportation; financial; telecommunications; and natural resources (including timber and integrated oil companies). The comments set forth in this submission reflect the views of the Institute as a whole, but more particularly those of our Canadian constituency.

1. Legislative Update

TEI invites a discussion and update on the Department's legislative priorities over the coming months.

A: TEI and DOF discussed priorities.

2. Tax Policy Development

TEI invites a discussion of the Department's views and perspectives on broad tax policy considerations, including the following:

- *The OECD BEPS initiative — Canada's perspective and objectives.* In July 2013 the Organisation for Economic Co-operation and Development (OECD) released a 16-point action plan to curb Base Erosion and Profit Shifting (BEPS). Many of the objectives are far-reaching in scope (*e.g.*, addressing the global digital economy) or seemingly call into question core principles of international taxation, such as the use of the arm's length principle to set transfer prices between related parties. Some countries have been vocal about what the initiative should address (*e.g.*, eliminating so-called stateless income) and what it should *not* address (*e.g.*, reallocating taxing rights between source and residence countries). What are Canada's views on the BEPS project? What would Canada consider as a successful outcome for the initiative? Which of the 16 goals (working parties or work groups) is Canada actively participating in and how?

- *Consultation Paper on Treaty Shopping.* The objective of OECD's BEPS action plan item number 6 is to develop recommendations on the design of domestic legislation to prevent treaty abuse. The Consultation Paper on Treaty Shopping released in August by the Department of Finance is also aimed at preventing treaty abuse, but the project seems far ahead of the OECD's projected September 2014 timeline for releasing recommendations. Hence the Department's report or legislative recommendations may be premature or potentially at odds with the recommendations released by the OECD. What preliminary indications or insights can the Department provide on its treaty-shopping initiative beyond the consultation document?

- *Overarching Design of the Canadian Income Tax System.* For the last 10 or more years, the government has been gradually reducing corporate tax rates and broadening the tax base. Is it safe to say, from the Department's perspective, that a broad-base, low-rate system is a core principle for the current and future design of the tax system as well as for specific provisions of the Income Tax Act (the Act)? Other core principles for taxpayers would include simplicity, administrability of the tax system, and predictability of the results of a taxpayer's transactions. Finally, avoidance of double taxation is critical. Does the

Department agree with these core principles for Canada's tax system? As the Department develops legislative proposals, does it conduct a review or apply metrics to ensure these principles are implemented? What other guidelines does the Department employ in crafting legislation?

A: TEI and DOF discussed the Department's perspective on matters such as BEPS and the Treaty Shopping consultation.

3. Carryover Issues

a. *Bilateral Safe Harbors*

In the 2012 agenda, TEI invited the Department's comments on the OECD's Discussion Draft on *Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines*. The Discussion Draft elicited comments from taxpayers and business groups on the benefits of adopting bilateral transfer pricing safe harbours for common, routine, or low-risk cross-border transactions. In its response, the Department acknowledged the potential benefits of adopting such provisions in Canada's treaties and said it would consider the final results of the OECD project. The Department also expressed interest in TEI's views in respect of priority areas for adoption of safe harbours, including interest rates and other common, routine, or low-risk transactions. In May 2013 the OECD concluded its project and recommended that taxpayers be permitted to elect bilateral or multilateral safe harbours for less complex transactions. In a related development, the U.S. Internal Revenue Service solicited comments to develop a model memorandum of understanding between competent authorities for certain transfer pricing issues, including the use of safe harbours for routine distribution functions.[1]

TEI is keenly interested in implementing safe harbours for transfer pricing of common, routine or low-risk transactions. Specifically, TEI recommends that the Department prioritize developing bilateral safe harbours for standardized markups for low-risk distributors and routine management services. We invite a discussion of the next steps in this process.

A: The Department agrees with the message in revised Chapter IV of the OECD *Transfer Pricing Guidelines* that there can be benefits to implementing a "safe harbor" approach; however, there is a need to proceed cautiously on this matter and to coordinate an approach with CRA. A preliminary analysis on safe harbours is underway and will review the approach taken by the U.S.

The Department is interested in TEI's perspectives with regards to safe harbours. More specifically:

[1] *See* IR-2013-30, March 15, 2013.

- What areas should be prioritized? For example, low risk transactions or management services?
- What is meant by low-risk distribution?

TEI will formulate a response and communicate with the Department.

b. *Automobile Benefits*

In Question 7 of the 2012 agenda, TEI noted that under CRA's assessing position (Technical Interpretation 2011-0399691I7 (June 28, 2011)) an employee might receive a taxable benefit for the full value of a vehicle when the company-leased vehicle is (1) completely destroyed in a collision and (2) self-insured by the company. In its response, the Department said that it would consider the effect of an employer's self-insurance of leased automobiles on an employee's taxable benefit amounts in the context of a broad review of automobile benefits. We invite a discussion of the status of the Department's review of automobile benefits.

A: Finance is aware of the issue and is reviewing, will discuss with CRA, and formulate an appropriate position.

c. *Subsection 15(2.1) Partnerships*

In response to Question 10 of the 2012 agenda, the Department said it was considering recommending relief in a future technical bill where subsection 15(2.1) catches a broader range of facts and circumstances than intended. We invite an update on the status of the Department's deliberations and the development of relieving legislation.

A: A number of concerns in this area have been sent by taxpayers to the Department. In a recent comfort letter, the Department noted that it was planning on issuing a future technical bill to address. A fix, however, is likely to be complicated and will need to take into account a number of inter-related matters.

d. *Functional Currency Reporting Rules*

In response to question 1(a) in the 2012 liaison meeting agenda relating to the functional currency reporting rules (which, in turn, was a follow-up to question 1(c) in the 2011 liaison meeting agenda and question 3 of the 2010 agenda), the Department said it had received a number of comments and submissions and would consider the functional currency reporting issues when internal resources become available. Since some of the Department's higher priorities, including Bill C-48, have now been addressed, we invite an update on the Department's review and prospects for legislative changes to clarify the functional currency rules.

A: Foreign currency is a complicated issue. The Functional Currency Reporting Rules ("Rules") were intended to apply to situations where business is legitimately conducted in a foreign currency. The Rules are not intended to apply where a Canadian business has only some foreign

currency transactions, and are not intended to provide beneficial tax planning opportunities. Further, the Rules have not always been applied consistently which may have at times lead to unintended results. The Department will not introduce amendments to the Rules that primarily facilitate tax planning, and indicated that certain issues can be resolved through CRA administrative guidance. The Department further referred to proposed legislation (released on July 12, 2013) that should generally provide relief to taxpayers in respect of some matters previously brought to the Department's attention.

4. Remission Order for Alberta Flooding

In June 2013 southern Alberta experienced heavy rainfall that triggered catastrophic flooding, which was described by the provincial government as the worst in Alberta's history. Indeed, the events in southern Alberta are comparable in the magnitude of destruction and loss to the Saguenay River flooding in 1996 and the Manitoba flooding in 1997.

CRA has released two interpretations, 2013-0494421E5 (June 27, 2013) and 2013-0496281E5 (July 12, 2013), providing guidance on disaster relief afforded to employees. Despite that helpful guidance, uncertainties remain about the proper tax treatment of amounts paid or benefits deemed to have been received as relief for a loss due to the southern Alberta flooding. Thus, a question arises whether broader humanitarian tax relief should be afforded to affected individuals and their employers. Specifically, has the federal government given consideration to issuing a remission order[2] with respect to amounts paid or benefits deemed to have been received as relief for loss because of the flooding in southern Alberta where those amounts are required to be included in income from employment of a taxpayer by virtue of paragraph 6(1)(a), 6(1)(b), or 6(9) of the Act and where the payment or deemed benefit is voluntary, reasonable, and bona fide? Remission orders of similar scope and nature were issued for the Saguenay River and Manitoba floods.

Alternatively, would the Department of Finance consider an amendment to the Act with respect to amounts paid and deemed benefits received as relief for loss due to a natural or other disaster so that such amounts are excluded from taxable income?

A: Since the Saguenay River flood, CRA has changed its position on disaster relief provided by employers to employees. CRA's previous position was that relief should be treated as employment income, and as such be taxable to employees and deductible to employers. CRA's new position is that the relief should no longer be treated as employment income and thus no longer be taxable to employees or deductible by employers.

[2] Remission orders are granted pursuant to subsection 23(2) of the Financial Administration Act in order to provide full or partial relief from federal taxes where such relief is otherwise unavailable under the tax laws. The decision to recommend relief is at the discretion of the Minister of National Revenue. Income tax remission cases are reviewed by the Legislative Policy Directorate and cases are vetted through the Headquarters Remission Committee. In addition, the Department of Finance must agree with the decision to provide relief. If a remission order is approved by the Minister of National Revenue, the draft order is sent to the Privy Council Office for approval by the Treasury Board.

Given the new CRA position on this matter, a remission order is not required to exempt employees from taxation. Finance has not considered any legislation or remission orders for employers.

5. Part VI Integration

The Part VI tax is assessed at a rate of 1.25 percent on the capital of each financial institution, but the tax can be offset and reduced by a credit for the Part I tax payable. Where there are multiple financial institutions within a corporate group, it can be challenging to effectively manage the Part I tax credit to ensure that the Part VI tax of all members is fully offset. Given the increasing regulatory pressure on financial institutions to strengthen their capital base and given that the federal government has eliminated all or nearly all forms of capital taxes, would the Department consider an amendment to eliminate or reduce the Part VI tax? Would the Department consider adopting an elective transfer mechanism (similar to the mechanism under Part VI.1 and paragraph 110(1)(k)) for either the Part I tax credit or the Part VI tax liability in order to facilitate the transfer of the liability to a related entity within a controlled group of companies?

A: The Department of Finance reviews the tax system on an ongoing basis, including the Part VI tax. This tax is viewed as a minimum tax and the suggested changes may put revenue at risk. With respect to the transfer mechanism, the Department is not clear whether such a change would be appropriate from a tax policy perspective. The Part VI.1 tax transfer is an exception to the more general principle of not allowing for the transfer of tax attributes among a controlled group of companies. The Department invites comments as to whether it is appropriate to extend this exception to Part VI tax.

6. Deemed Stock Option Benefit on Death

Where an employee holds unexercised stock options at the time of death, paragraph 7(1)(e) of the Act deems the employee to receive an employment benefit in the year of death equal to the amount by which the value of the stock options immediately after death exceeds the amount paid by the employee to acquire the options. Where an option is automatically cancelled on an employee's death, the value immediately after death would be nil, and no amount would be included in the employee's income under paragraph 7(1)(e). If, on the other hand, the option's terms permit the employee's estate to exercise the options for a period following the employee's death, paragraph 7(1)(e) may trigger an income inclusion for the employee in his last taxation year.

CRA has issued a technical interpretation (2011-0423441E5(F) (December 11, 2012)) expressing the view that subparagraph 110(1)(d)(i) precludes a deduction under paragraph 110(1)(d) where a deceased employee is deemed to receive a taxable benefit as a result of paragraph 7(1)(e). Under the interpretation, subparagraph 110(1)(d)(i) only applies when the security is acquired by *the taxpayer* pursuant to a stock option agreement. In the case of unexercised stock options held at the time of death, the deceased employee would not qualify for

the paragraph 110(1)(d) tax deduction because the deceased employee is *deemed* to have received a stock option benefit pursuant to paragraph 7(1)(e) without having actually acquired the shares (*i.e.*, the stock options are exercised by the deceased employee's estate so the stock is *not* acquired by the employee). Consequently, where paragraph 7(1)(e) applies after March 4, 2010, a deduction pursuant to paragraph 110(1)(d) may not be available.

The result in the CRA interpretation seems inequitable for employees holding unexercised options at death. Had the option holder in the technical interpretation exercised the options prior to death, the resulting stock option benefit would have only been 50 percent taxable. Is the Department aware of CRA's interpretation and its effect on an option exercised by a deceased's estate? Will the Department review the interpretation and consider amending paragraph 110(1)(d) to afford a tax deduction where a deemed stock option benefit results from the application of paragraph 7(1)(e)? Presumably, the intent of paragraph 7(1)(e) is to deem an income inclusion on death similar to an actual option exercise. As important, the 2010 Federal Budget amendments to paragraph 110(1)(d) and the introduction of subsection 110(1.1) were presumably intended to address stock option cash-outs where *both* the employee and the employer are eligible for tax deductions. We invite the Department's response.

A: The Department is aware of CRA's interpretation with regards to this matter and officials have discussed it with them. Finance considers that this situation may be an unintended consequence of the rules and is investigating whether there is an appropriate fix. In the meantime, the Department invites taxpayers to reach out should they require temporary relief.

7. Statute of Limitations: Loss Years

In a year where a taxpayer has section 3 income, CRA is obliged to make an initial assessment "with all due dispatch." The government's ability to reassess (absent deliberate or negligent misrepresentation by the taxpayer) expires within specified periods following the initial assessment. The same rules apply for a year when a taxpayer has a non-capital loss or a net capital loss, but the rules do not have the same effect because losses carry forward and their quantum remains open to adjustment until the year in which the losses are used or become statute barred.

Subsection 152(1.1) of the Act affords a process for fixing the quantum of a loss, but the process can begin only after CRA has "ascertained" that the loss differs from the amount reported by the taxpayer. That determination by CRA might occur 20 or more years after the year the loss is incurred, thereby creating substantial uncertainty for taxpayers about their tax position and subjecting taxpayers to a burdensome requirement to maintain records of the year of the loss until the loss amount is "ascertained."

TEI recommends that the Department consider an amendment to the Act that would require CRA to make initial determinations of losses for a taxation year at the same time and in the same manner as the initial determination of income for that year. We invite the Department's response.

A: In policy terms, Finance would support an interpretation of subsection 152(1.1) that allowed a taxpayer to request that the amount of a loss be determined when the taxpayer files its return. If this interpretation is correct, Finance sees no need for an amendment. If the provision does not allow this, the Department could review the wording of the rule and consider recommending an amendment.

8. Restrictive Covenants

The definition of restrictive covenant in subsection 56.4(1) is very broad. Except in certain limited circumstances, amounts received under a restrictive covenant are treated as ordinary income under subsection 56.4(2). The exceptions to ordinary income treatment in subsections 56.4(3), 56.4(6), and 56.4(7) apply to a narrow subset of restrictive covenants (*i.e.*, non-compete covenants), but seemingly do not apply to other common covenants provided in connection with the purchase and sale of a business. For example, customer and employee non-solicitation covenants do not qualify for the exceptions even though — just like non-compete covenants — they are negotiated between a buyer and seller to maintain and preserve the value of the business sold. From a tax policy standpoint, it is unclear why relief is afforded only for non-compete covenants. Would the Department consider eliminating subparagraph 56.4(3)(c)(ii) and paragraphs 56.4(6)(d), 56.4(7)(b), and 56.4(7)(c) from the Act, thereby expanding the scope of relief in section 56.4 to all restrictive covenants that are designed to protect the value of a business that is subject to a purchase and sale agreement?

A: The provision was intentionally drafted to be broad. If further clarity is needed, the Department recommends that taxpayers work with CRA to determine what might or might not constitute a non-compete covenant.

9. Subsection 250(5)

There are substantial and significant differences in tax consequences for outbound investments by Canadian companies that depend on the determination of the residency of the foreign investment. Hence, Canadian enterprises ensure that their outbound investments in active businesses are carried on through foreign subsidiaries resident in jurisdictions with tax treaties or tax information exchange agreements (TIEA). Because of the uncertainty associated with the factual determination of the common law test of residency, significant expense is often incurred to ensure that the central management and control of a foreign subsidiary is exercised in the foreign jurisdiction. CRA also expends significant resources auditing issues relating to the location of the central management and control of foreign subsidiaries of Canadian enterprises.

TEI believes the administrative efforts and expenses incurred by Canadian enterprises in establishing, and CRA in confirming, the central management and control of foreign subsidiaries seem unnecessary where (a) a foreign subsidiary of a Canadian enterprise earns active business income in a treaty country; (b) the subsidiary is subject to foreign tax as a resident of that jurisdiction; (c) the subsidiary is regarded as resident only in that jurisdiction under the tax treaty; and (d) subsection 250(5) of the Act applies to deem the subsidiary not to be resident in Canada. For example, assume a taxable Canadian corporation (Canco) has a wholly-owned subsidiary (USco) that is incorporated under the laws of a U.S. State and earns active business

income in the United States. USco is a resident of the United States for U.S. tax purposes. Assume that, because some high-level strategic decisions are made in Canada, there is a risk that the central management and control of USco may be considered to be in Canada for Canadian tax purposes. If USco were resident in Canada under the central management and control test, the tie-breaker rule in the Canada-U.S. tax treaty would treat USco as resident solely in the U.S. In addition, subsection 250(5) would apply to deem USco not to be resident in Canada for purposes of the Act.[3]

Question:

In order to (i) reduce compliance burdens of Canadian enterprises and administrative burdens of CRA and (ii) enhance tax certainty, would the Department of Finance consider amending subsection 250(5) so that, where a corporation is regarded as resident only in another jurisdiction under a tax treaty, that corporation is deemed (i) not to be resident in Canada and (ii) to be resident in that jurisdiction for purposes of the Act and Regulations? Alternatively, would the Department consider amending subsection 250(5) for purposes of computing surplus accounts derived from active business income without reference to paragraph 95(2)(a)?

Canada has approximately 50 tax treaties with corporate tie-breaker tests based on place of incorporation, creation, or nationality, including those with the United States and Australia. (Other tax treaties rely on residency determinations by the competent authorities). Adoption of TEI's suggested amendments would move Canada closer to a full exemption system as recommended by the Advisory Panel on Canada's System of International Taxation.

A: The Department is aware of and sympathetic to the issues but will await further global developments in the area before recommending any changes.

10. Interaction of Subsections 18(4) and 91(1)

Question 6 of the 2009 liaison meeting agenda illustrated that the lack of coordination between subsections 18(4) and 91(1) on the treatment of interest (hereinafter "Interest") on a loan from a controlled foreign affiliate (CFA) of a Canadian parent (CP) to a Canadian subsidiary (CS) of the same Canadian parent (CP) can lead to double taxation of the same amount. In the example, the deduction of the Interest expense is denied (hereinafter the "Denied Interest") to CS pursuant to subsection 18(4), but the FAPI corresponding to the Interest income for CFA included in the taxable income of CP is not reduced by the amount of the Denied Interest.

In its response, the Department acknowledged the inconsistent treatment and potential double taxation but expressed uncertainty about whether the proper solution involves a change to

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[3] In the example, if USco were, in fact, resident in the United States under the central management and control test, then earnings of USco would be included in exempt earnings and dividends paid by USco to Canco would be paid out of exempt surplus and, consequently, not subject to additional tax in Canada. If the central management and control of USco were determined to be in Canada rather than the United States, the earnings of USco would be included in taxable earnings and dividends paid by USco to Canco would be considered to be paid out of taxable surplus. Underlying foreign tax would then be allowed as a deduction against the surplus.

the FAPI rules or to the thin capitalization rules. TEI believes that, in principle, the way forward has been addressed in subsection 18(8) wherein the Denied Interest is reduced to the extent FAPI is included in income in respect of the Interest. Thus, to address the above example, we believe subsection 18(8) should be amended to allow a deduction for Interest treated as FAPI and included in the income of any person related to CS (*i.e.*, CP). We invite the Department's reaction to this potential solution.

A: The Department is sympathetic but would need to assess the importance of the issue in the context of competing priorities at this time.

11. Prohibited Investment Rules

The prohibited investment rules for Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs), and Tax Free Savings Accounts (TFSAs) have been extended to apply to retirement compensation arrangements (RCAs). The December 21, 2012, proposed legislative amendments affording an "excluded property" exemption for portfolio interests (*i.e.*, a less than 10-percent interest) for RRSPs, RRIFs and TSFAs, however, was not extended to RCAs. Would the Department consider an amendment to conform the RCA prohibited investment/advantage rules to the December 21, 2012, proposals for RRSPs, RRIFs and TFSAs?

A: The Department is prepared to consider this matter as it would generally seem to make sense to have consistency among the deferred plans, however, current work load is significant and there is a need to prioritize.

12. Effective Date of Legislation

Given the significant delays that can arise between the date that proposed legislation is announced and the date of Royal Assent, there can be significant benefits or detriments where legislation is effective from its announcement date rather than the date of Royal Assent. Would the Department of Finance provide a summary of the circumstances in which proposed legislation is drafted to be effective "on Royal Assent" — as was the case with the recent amendment to subsection 99(1) — as opposed to being effective from the date of announcement?

A: The effective date of legislation and how and whether to provide transitional rules in relation to tightening changes is considered carefully for every tax change. Any effective date later than announcement date carries the risk of causing revenue losses for the Government. Imposing new tax rules on announcement also ensures that a minority of taxpayers do not continue to benefit from unintended tax preferences. At the same time, taxpayers generally need adequate time and reasonable mechanisms to adjust to new rules. The Department also considers submissions with respect to tightening changes where impacts are unanticipated or more severe than may have been anticipated.

It is not possible to enumerate all of the situations where legislation will come into force on Royal Assent, as opposed to on announcement; however, we can provide some examples of situations where it is appropriate for legislation to come into force on Royal Assent:

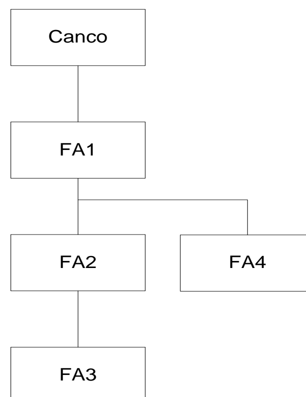
- Sometimes legislation needs to be in place in order to authorize certain actions, for instance, where a provision is amended authorizing a government official to disclose taxpayer information, the amendment will typically come into force on Royal Assent.
- If an amendment is merely clarifying and is not expected to have an effect on a taxpayer's behaviour or their liabilities under the Act, it may be appropriate for the amendment to come into force on Royal Assent. For example, the bijuralism amendments that were contained in Bill C-48 came into force on Royal Assent. Another example would be a situation where the CRA and taxpayers are already applying a provision consistent with its intent, and the legislation is amended simply to clarify that application.

13. Foreign Mergers

TEI welcomes the enactment of subsection 87(8.2) because the provision provides clarity and uniformity in the treatment of share exchanges for many absorptive foreign mergers (where one, but not all, of the merging foreign corporations survives). Regrettably, the provision may not be broad enough to fully achieve its purposes. There are situations where unexpected or seemingly inconsistent results arise from similar economic transactions. Two examples follow:

a. *Example 1 - Foreign Affiliate Merger*

In certain cases, a triangular foreign merger (*i.e.*, a "foreign merger" within the meaning of subsection 87(8.1) as a result of the application of subsection 87(8.2)) can result in the disappearance of the adjusted cost base of the shares of the relevant foreign affiliates. A common pre-merger structure is summarized in the following diagram with FA4 owned by FA1.



Assume a merger of FA4 into FA3 where FA3 is the survivor and no shares are issued upon the merger. The merger is considered an "absorptive merger" because a foreign predecessor corporation survives. Unless subsection 87(8.2) applies, the merger may not qualify as a "foreign

merger" under subsection 87(8.1) since FA3 is the sole survivor corporation and is not a "new foreign corporation." Subsection 87(8.2) provides a series of deeming rules for purposes of the definition of "foreign merger," which may change this result (allowing a merger with a sole survivor to qualify).

The deeming rule in paragraph 87(8.2)(f) provides that all of the shares of the capital stock of each predecessor foreign corporation (other than the survivor corporation) that was outstanding immediately before the merger or combination and that ceases to exist as a consequence of the merger or combination is deemed to be exchanged by the shareholders of each such predecessor corporation for shares of the survivor corporation. As a result, the shares of FA4 are deemed exchanged for shares of FA3 and under subsection 87(4) the cost of FA1's shares of FA4 is deemed to be added only to the shares of the survivor (FA3) and not to the shares of the foreign parent corporation (FA2).

TEI believes that paragraph 87(8.2)(f) should mirror paragraph 87(8.1)(c) such that the shares of FA4 should be deemed to be exchanged for shares of the survivor or, in case of a triangular merger, for shares of the foreign parent corporation. Such a modification to subsection 87(8.2) would cause subsection 87(4) to apply so that the adjusted cost base of the shares of FA4 would be added to the shares of FA2. Would the Department of Finance consider making the appropriate changes?

b. *Example 2 - Merger of Foreign Corporations that hold Taxable Canadian Property*

Assume two U.S. corporations, USCo1 and USCo2, desire to merge in a transaction that is tax-free for U.S. tax purposes. USCo1 holds all of the shares of USCo2. Under U.S. tax laws, the merger may be structured so that either USCo1 or USCo2 survives. Regardless of whether USCo1 or USCo2 is the surviving corporation, the transaction is generally not taxable to either company in the U.S. For Canadian tax purposes, CRA takes the position that the non-surviving corporation has disposed of its assets for proceeds equal to the fair market value of the assets at the time of the merger so any gain inherent in TCP held by the non-surviving corporation is deemed sold and taxed. Where USCo1 holds TCP but USCo2 does not, the merger will not trigger a taxable disposition in Canada as long as USCo1 is the survivor. If USCo2 is the survivor, the merger will result in a taxable disposition of the TCP held by USCo1 even though the two mergers are economically equivalent and receive the same treatment for U.S. tax purposes (*i.e.*, both are tax-free transactions in which the surviving corporation inherits the tax attributes (including tax basis in the assets) of the non-surviving corporation. Does the Department agree that subsection 87(8.2) provides no relief with respect to the disposition of TCP by USCo1? The policy rationale for taxing the foreign tax-deferred merger in Canada under such circumstances is unclear. In many cases, contractual commitments or regulatory restrictions inhibit the corporate group's ability to freely structure the form of the merger transaction (and determine the survivor) to avoid a disposition of TCP. Continuing the above example, assume USCo2 holds a nontransferable license. Any attempt by the group to rationalize and streamline its corporate structure would require USCo2 to be the survivor, thereby triggering the gain to USCo1.

In addition, where a corporate group is formed through a series of mergers and acquisitions, related foreign corporations in the corporate group, such as USCo1 and USCo2,

will often hold interests in the same TCP. Where both USCo1 and USCo2 hold TCP, a U.S. tax-free merger would trigger a Canadian taxable disposition in either USCo1 or USCo2. For example, assume USCo1 owns all the shares of USCo2 and USCo1 and USCo2 each hold 50 percent of the shares of Canco, which are TCP. Depending on how the merger is structured, a U.S. tax-free merger of USCo1 and USCo2 will result in a taxable disposition of the Canco shares held by either USCo1 or USCo2. Does the Department agree that subsection 87(8.2) is too narrow to provide relief in this situation and that a foreign merger of USCo1 and USCo2 would result in a taxable disposition of TCP to at least one of the merging parties (*i.e.*, the non-survivor)?

If the Department agrees that subsection 87(8.2) provides no relief in the examples in the above paragraphs, would the Department consider an amendment to the Act to provide for tax-deferred treatment of the disposition of TCP in circumstances similar to those described above (*i.e.*, where USCo1 and USCo2 are resident in the same country, related to each other immediately prior to the merger, and no non-share consideration is received by a shareholder in connection with the merger)?

A: The Department is sympathetic to both examples and is prepared to consider recommending broadening amendments in this area, but does not want to proceed on a piecemeal basis. The Department would seek further input from taxpayers as to the kinds of circumstances they encounter before proceeding further.

More specifically with regards to Example 1, there may be other similar circumstances that also merit a broadening of the provisions, and it is the Departments preference to only make changes once. The Department, therefore, requests a list of all similar scenarios that should be included in a broadening amendment.

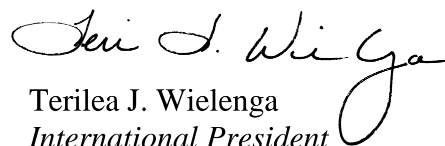
With regards to Example 2, the Department may consider under narrow circumstances a situation in which there is a same-country merger, no non-share consideration is received, and the ultimate owner is unchanged.

Conclusion

Tax Executives Institute appreciates the opportunity to present its comments in respect of pending income tax issues. We look forward to discussing our views with you during the Institute's December 4, 2013, liaison meeting.

Respectfully submitted,

Tax Executives Institute, Inc.

By: 

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