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

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October 6, 2010

Mr. Brian Ernewein
General Director, Tax Legislation Division
Tax Policy Branch
Department of Finance
L'Esplanade, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G5

Re: Addendum – September 27, 2010 Submission on August 27, 2010 Draft Legislation

Dear Mr. Ernewein,

Please find attached an addendum to our September 27, 2010 submission on the August 27, 2010 Draft Legislation.

We trust you will find our comments helpful. As always, members of the Joint Committee would be pleased to meet with you to discuss our submission further at your convenience.

Yours very truly,

D. Bruce Ball
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Elaine Marchand
Chair, Taxation Section
Canadian Bar Association

Submission of the Joint Committee on Taxation of The Canadian Bar Association and the Canadian Institute of Chartered Accountants regarding the August 27, 2010 Draft Legislation ("Draft Legislation")

ADDENDUM

1. Foreign Tax Credit ("FTC") Generator Rules

The proposed FTC generator rules included in subsections 91(4.1) to (4.5)[1] of the Draft Legislation differ significantly from the original proposals contained in the Notice of Ways and Means Motion issued with the Federal Budget on March 4, 2010. Once these rules apply, they appear to affect all foreign affiliates of all Canadian companies in a related group, and are not isolated to a particular affiliate group located in a jurisdiction where a hybrid instrument exists or for that matter where tax that is not paid is generated under the existing rules for purposes of claiming Canadian tax relief. Additionally, the proposed rules also appear to apply to hybrid instruments issued by a Canadian entity to a Canadian entity.

March 4, 2010 Budget Proposals

In the Federal Budget, the government announced its intention to target Canadian companies that were engaging in fairly narrow "foreign tax credit generator schemes" designed to shelter tax on interest income from indirect loans to foreign corporations. In fact, the Budget documents specifically indicated that the "schemes" being targeted were those that "artificially created foreign taxes" that were being claimed by Canadian corporations as a credit or deduction in order to offset Canadian taxes. Clearly, the focus of these proposals, at least from a policy perspective as indicated in the Budget, is to ensure that foreign taxes that have never in fact been paid, or that are paid and then refunded by a foreign government, are not eligible to be claimed as a credit or deduction in Canada.

It is our understanding that, in general, the "schemes" referred to in the Budget documents were being implemented by unrelated parties. In fact, an unrelated third party example of such a transaction was presented by the Department of Finance at the IFA Conference held in Montreal in May 2010.

Draft Legislation

The new rules deny FTC claims and deductions for foreign accrual tax ("FAT") and underlying foreign tax ("UFT") where a foreign jurisdiction considers, under its tax law, the Canadian

[1] All references to sections, subsections, etc. are to provisions of the Income Tax Act, as proposed to be amended under the August 27, 2010 Draft Legislation

corporation to have a smaller direct or indirect interest in a foreign entity within the related group than the Canadian corporation is considered to have for Canadian tax purposes.

Specifically, foreign taxes will not be recognized if the foreign affiliate's jurisdiction views a "pertinent person or partnership" as having a lesser direct or indirect interest in the foreign affiliate under its tax law than that person (or partnership) has for Canadian tax purposes (under subsection 91(4.1)). The companion rules relating to UFT, in Regulations 5907(1.03) to (1.06), reflect similar changes, and affect the opportunity for claiming relief for taxes paid on taxable earnings such as those from active businesses carried on in non-treaty jurisdictions.

A "pertinent person or partnership" is a person or partnership that is the taxpayer, a person (other than a partnership) resident in Canada that does not deal at arm's length with the taxpayer, a foreign affiliate of the taxpayer or of a pertinent person or partnership of the taxpayer, or a partnership having a pertinent person or partnership in respect of the taxpayer as a member, as generally defined in proposed subsection 91(4.5).

However, a "pertinent person" will not be considered to own less than all of the shares of a particular corporation under the foreign tax law that are considered to be owned under Canadian tax law solely because the pertinent person or the corporation is treated as a disregarded entity under foreign law, under subsection 91(4.2). A similar exclusion for a partnership is found in subsection 91(4.3).

The proposed FTC generator rules are effective for foreign taxes incurred in taxation years that end after March 4, 2010, with transitional provisions (reflecting the narrower 2010 Budget proposals) that will apply to taxation years that end on or before August 27, 2010. Because the rules can apply at "any time in the year", it will not be possible to unwind an "offside" structure to ensure that the rules do not apply in the current taxation year.

Example in Explanatory Notes

The first example outlined in the Explanatory Notes illustrates a typical internal "REPO" structure, whereby an instrument that is treated as an equity investment under Canadian tax rules is treated as debt under US tax rules. In this example, the US group is generating FAPI, and as a result of the new rules, any US tax paid in respect of that FAPI will not be deductible by the Canadian corporation as FAT.

Three points are worth noting in this regard. First, the structure in the example is generally one that is implemented between related parties. Second, the US tax that is being paid in the affiliate group is true foreign tax – it is not "phantom" foreign tax that is being generated artificially. Third, the example clearly contemplates that the FAPI in the affiliate group is being earned in the same jurisdiction in which the hybrid instrument is in place.

The first two points seem to highlight a discrepancy between the policy underlying the introduction of the rules, as outlined in the Budget, and the potential application of the rules as drafted. If the rules are in fact aimed at "schemes" undertaken between unrelated parties with a

view to claiming deductions for artificial foreign tax, then they clearly are overly broad and not at all focussed on the policy intention.

Broad wording of rules can catch unintended situations

The third point noted above highlights a fundamental issue that arises as a result of the broad wording of these rules. Because of the definition of "pertinent person or partnership" as indicated above, a deduction for FAT or UFT may be denied to a Canadian corporation no matter where the tax and related FAPI is being generated if there is a share investment anywhere in the corporate group that is treated as debt in the jurisdiction where FAPI or taxable surplus is earned.

Example 1

> A REPO structure is in place in the US, and FAPI is being earned in a completely different jurisdiction, say Spain. Depending on how Spain characterizes the hybrid instrument, any Spanish tax being paid on the FAPI will potentially be denied.

The rules do not in any way link the interest deduction being claimed under the hybrid instrument (in this example, the US) with the FAPI and foreign tax being generated (in this example, Spain).

The breadth of the rules will also potentially cause FAT deductions to be denied in cases where an instrument is in place between Canada and another jurisdiction, but the instrument is not in fact creating an interest deduction.

Example 2

- Canco owns shares of FA1 and FA2
- FA1, a resident in country A, has issued preferred shares to Canco
- FA2, a resident of country B, is a sister to FA1 but there are no intercompany balances or ownership between the two companies
- Country B would treat FA1's preferred shares as debt while country A treats the preferred shares as equity
- FA2 earns FAPI or carries on business in a non-treaty jurisdiction and pays tax at a high rate of 35%, or for that matter Canadian tax such as withholding tax on interest paid on an upstream loan.

Under the Draft Legislation, as country B would treat the preferred shares as debt, Canco would not be entitled to relief for taxes paid by FA2, even though neither FA1 nor FA2 is benefitting from a tax deduction for dividend payments on the FA1 preferred shares.

To avoid the application of the rules in this example, the preferred share investment must either be unwound or Canco must ensure that no entities within its foreign affiliate group have taxable surplus or FAPI. In large multinational groups, this is simply not possible and should not be necessary to achieve the objective of the rules. FAPI arises for many reasons, including from excess cash generated in jurisdictions that limit distributions, and from inter-affiliate loans that

are required for business purposes but do not meet the specific requirements of the recharacterization rules. As well, many affiliates generate FAPI from carrying on an investment business where the greater than 5 employee test is not met, such as could be the case with many mining, real estate or technology companies. Many Canadian multinationals pay tax on FAPI or taxable surplus and it is unfair for such companies to be denied a deduction for actual foreign tax that is being paid on the earning of that FAPI simply because there are preferred shares, somewhere in their Canadian foreign affiliate structure.

Another impractical effect of the proposals involves the requirement to determine whether an instrument is classified as equity or debt in a jurisdiction that has no relation to the issuance and acquisition of that instrument in the first place. In our example 1 above, the tax law in Spain would need to be examined in order to determine the classification of the instrument in place between Canada and the US. If the tax laws in Spain do not even contemplate the existence of such an instrument, it would be impossible to obtain any comfort. In large multinational groups, this determination will need to be made in *every* jurisdiction in which FAPI or taxable surplus could be earned and result in taxes, for *every* share issued anywhere in the group. The compliance burden will be enormous for virtually every Canadian based multinational in Canada – and these proposals were not even targeted at these structures to start with.

A final example serves to highlight how the breadth of the rules can cause them to apply in unexpected situations.. In the example above, assume that the preferred shares are issued by CanSub, a Canadian subsidiary of Canco, to Canco. Again, because of the definition of "pertinent person", these preferred shares will be caught within the ambit of the rules, and their classification will need to be determined under the tax law of any jurisdiction in which a foreign affiliate of Canco generates FAPI or taxable surplus and pays foreign tax. We believe this result is well beyond the policy underlying the introduction of these rules..

Recommendation: We recommend that the FTC generator rules be amended to address these concerns. In particular:

(i) The policy intent behind the introduction of the rules should be more clearly reflected in the rules themselves. If the rules are in fact meant to catch "schemes" that are entered into between unrelated parties and that generate "artificial" foreign tax, then they should be drafted as anti-avoidance provisions targeted at taxpayers that undertake such transactions. As currently drafted, the FTC generator rules are overreaching and will apply to many Canadian based multinationals that were not intended to be caught.

(ii) The application of the rules should not extend to cases where there is no link between the jurisdiction where the FAPI (or taxable surplus) and foreign tax are being generated, and jurisdiction governing the issuer of the hybrid instrument. If a hybrid instrument is treated the same from the perspective of Canadian law and the relevant law of the jurisdiction of the issuer of the instrument (thereby ensuring that the instrument is in fact not a hybrid instrument), there should be no reason to then have to analyze the instrument under the laws of every other jurisdiction in which FAPI or taxable surplus generating foreign affiliates in the

group are resident. This will quite often be extremely impractical, and could be impossible given the complex corporate and tax legislation in place in certain jurisdictions around the globe.

(iii) If the instrument in question is in place between Canadian entities, there should be no requirement to have to analyze the instrument under the tax laws of any other jurisdiction.

(iv) Because the proposed rules apply "at any time in the year", they could affect a taxpayer's current taxation year, increasing its Canadian tax liability on any FAPI or dividends paid from taxable surplus. There is no ability for taxpayers to restructure their hybrid instruments, or to manage their exposure to mitigate the effect of these rules prior to the end of this taxation year. The coming-into-force provisions for these rules should provide that they only apply to taxation years beginning after the Announcement Date (August 27, 2010) for taxpayers to have sufficient time to restructure their investments.

2. Section 237.3 – "Confidential protection" Hallmark

Paragraph (b) of the definition of "reportable transaction" in subsection 237.3(1) provides that a hallmark exists where an advisor or promoter in respect of the avoidance transaction or series, or any person who does not deal at arm's length with the advisor or promoter, has or had confidential protection in respect of the avoidance transaction or series.

"Confidential protection" in respect of a transaction or series means "anything that prohibits the disclosure to any person or to the Minister of the details or structure of the transaction or series under which a tax benefit results.

As currently drafted, this hallmark is sufficiently broad to capture the prohibition on disclosure imposed on a lawyer by virtue of solicitor-client privilege. Solicitor-client privilege extends to all communications between a lawyer and a client made with a view to providing or receiving legal advice where such communications are intended to be confidential. The privilege belongs to the client; it is a duty of the lawyer.

Reading the definition of "confidential protection" with paragraph (b) of the definition of "reportable transaction", it appears that the hallmark will be present where a promoter or advisor has or had *anything* that prohibits disclosure. The hallmark literally captures the situation where the promoter or advisor has *a duty or obligation* that prohibits disclosure to another (as well as the situation where the advisor or promoter has *a right* to prevent disclosure). Thus, we are concerned that this hallmark captures the lawyer's duty of confidentiality in respect of communications between the lawyer and a client concerning the details or structure of a transaction with a view to providing or obtaining legal advice. While the Explanatory Notes state that paragraph (b) refers to the circumstance in which an advisor or promoter "obtains" confidential protection, thereby suggesting that the provision is intended to apply where the

advisor is entitled to confidentiality (as opposed to being bound by a duty of confidentiality to another), proposed paragraph (b) is not similarly limited.

Recommendation:

We recommend that the definition of "confidential protection" be amended to specifically exclude a prohibition on disclosure imposed on a lawyer that results from solicitor-client privilege. If it is not possible to create such an exclusion, we suggest that the words "has or had" in paragraph (b) of the definition of "reportable transaction" be replaced with an expression that better targets the types of confidentiality that the Explanatory Notes suggest is intended to be caught, i.e. confidentiality undertakings obtained by an advisor or promoter from another in respect of an avoidance transaction, so as to prevent paragraph (b) of the definition of "reportable transaction" from being construed to capture solicitor-client privilege.