A Possible Framework for an Expanded Exemption System:

A Submission to the Advisory Panel on Canada's System of International Taxation

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This is a submission to the Advisory Panel on Canada's System of International Taxation (the "Panel"), in response to the request made in the Panel's April 25, 2008 report, "Enhancing Canada's International Tax Advantage – A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation" (the "Consultation Paper").

Scope and Background

This submission represents my own personal views and is not intended to be representative of any consensus of my tax partners or our law firm as a whole.[1]

It is sometimes the case that high level tax policy discussions can be made more useful with a "reality check" or assessment of the practical consequences of different policy choices. Often

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"the devil is in the detail", such that the actual implications of a particular tax policy alternative do not become fully apparent until the ideas are worked through and applied in the context of the web of other existing rules. This submission therefore attempts to explore one possible way that an expanded exemption system might actually operate in practice, along the lines suggested in the Consultation Paper. This is not an attempt to address all of the issues raised in the Consultation Paper – the submission is focused on the foreign affiliate and FAPI rules and it is deliberately somewhat technical and informal in style.

This is an updated version of the draft submission first provided to the Panel on May 25, 2008. Among other things, it takes into account the comments received from Nick Pantaleo and Brian Mustard at our meeting in Toronto on June 11, 2008.

Statutory references in this submission are to the *Income Tax Act* (Canada) (the "ITA") and the Regulations thereunder.

A Possible Design for an Expanded Exemption System

The Consultation Paper has asked intriguing questions about whether, and how, Canada's foreign affiliate system should be modified into a broader exemption system for active business income. From my perspective as a tax practitioner, the answer to the first part of the question is clearly yes, the exemption system should be expanded. Here the work of Scott Wilkie and Nick Pantaleo for the IFA (Canadian Branch) 2007 Travelling Lectureship, "The Canadian Foreign Affiliate System: Are the Surplus Rules Surplus?" must be acknowledged. This submission supports the theme of their work, and their reasoning why Canada should "consider reorienting the rules more directly to achieve territorial taxation of foreign business income".

Having accepted this general premise, which is clearly also the direction suggested in the Panel's Consultation Paper, the more challenging part of the question is how and in what manner the objective of a broader exemption system should be achieved. This is where it may be helpful to assess the possible changes in the context of a more detailed foreign affiliate system proposal. There are many possible ways the current foreign affiliate rules could be changed to broaden the exempt surplus system. This submission outlines the principal features of one such possible alternative, including the specific components of income that might be included in exempt surplus. The purpose of this submission is to propose further technical detail to flesh out the general objective of expanding the current exemption system, in an effort to explore how a broader exemption system for foreign source active business income might integrate with the foreign accrual property income ("FAPI") and foreign investment entity ("FIE") rules. This exercise demonstrates that such an expanded exemption system could potentially be quite practical and workable, in a manner consistent with Canada's tax policy objectives, and with substantial simplification compared to the current system.

Overview of the Proposed Expanded Exemption System

- The main thrust of this proposed system, consistent with the Wilkie/Pantaleo 2007 IFA Travelling Lectureship and with the direction suggested in the Panel's Consultation Report, is to extend exemption treatment to all active business income earned by foreign affiliates in any country, regardless of whether Canada has a tax treaty or tax information and exchange agreement ("TIEA") with such country. This could be said to promote capital import neutrality and capital ownership neutrality with respect to foreign-source business income.

- It is acknowledged that moving to a full exemption system for all active business income implies abandonment of the recently enacted TIEA rules and the apparent incentive for tax haven countries to enter into tax information and exchange agreements with Canada. In other words, it is possible that under the current system, countries which do not currently have a tax treaty with Canada might be encouraged to conclude a TIEA with Canada in order to benefit from exempt treatment for active business income earned in their jurisdiction. However, this incentive (which in any event might easily be overstated) would be lost under the proposed system in which Canada unilaterally extends full exempt treatment to all active business income earned anywhere. If a continued incentive is considered desirable to encourage tax haven countries to enter into a TIEA, perhaps this could be provided through the proposed FIE rules. The FIE rules adopt an entity-based approach -- if the foreign entity is a FIE then 100% of its income is potentially subject to Canadian tax under one of the three alternative methods. This could allow special, more favourable treatment to non-resident entities that are resident in TIEA countries, and more punitive treatment for non-resident entities in non-treaty non-TIEA countries. By way of example, the exempt interest definition could be modified to ease the requirements for exempt interest status for participating interests in non-resident entities resident in a TIEA country.

- Investment income generally would continue to be taxed largely as it is under the current system – current taxation of FAPI earned in a controlled foreign affiliate and deferred taxation of FAPI otherwise, subject to possible current taxation under the overlapping FIE proposals.

- o Property income earned by controlled foreign affiliates would continue to be taxed under the FAPI rules essentially as under the current system, on a current imputation basis under subsection 91(1). This could be said to promote capital export neutrality with respect to highly mobile property income.

- o Property income earned by foreign affiliates that are not controlled foreign affiliates would be taxed currently in the hands of the Canadian shareholder only if it is captured by the proposed FIE rules. These FIE rules would assume a greater importance under the full exemption system proposed here, and could potentially be modified to more overtly target property income earned in non-controlled foreign affiliates. Property income not caught by the FIE rules would nonetheless potentially be taxed in Canada as a capital gain when the foreign affiliate shares are disposed of or when distributions are made to the Canadian shareholder exceeding exempt surplus and adjusted cost base. This is a modified version of the current deferral of taxation of FAPI earned by a non-controlled foreign affiliate.

- The exemption system proposed in this submission does not follow a "participation exemption" model. In particular, consideration has been given to a broadening of the exemption system that would also fully exempt from Canadian taxation all capital gains realized from dispositions of foreign affiliate shares that meet the excluded property test, including dispositions by Canadian taxpayers of their top-tier foreign affiliates. An exemption system of such scope would permit considerable simplification of the foreign affiliate rules because it might not be necessary even to maintain an exempt surplus account, since all foreign-source active business income and capital gains income would be fully exempt. On the other hand, some variations of a participation system might still require calculation of a "safe income" amount in a manner similar to subsection 55(2) in the domestic context. One of the challenges of such a broad "participation exemption" system is whether and how to tax accrued property income earned in non-controlled foreign affiliates. This submission assumes it is more likely that the Panel, and the Department of Finance, will not be able to get fully comfortable with a full participation system that wholly relinquishes Canada's jurisdiction to tax capital gains realized from dispositions of foreign affiliate shares. Therefore, and also for the reasons that will be described below, this submission does not propose adoption of a full "participation exemption" system. Instead, this submission proposes that potential Canadian capital gains taxation of foreign-source capital gains be retained, which in turn requires that exempt surplus balances are maintained. This proposed system could therefore be described as a modified, simplified and expanded version of the current exempt surplus system, with changes that are evolutionary rather than revolutionary.

- Consideration has been given to the ownership threshold required for "foreign affiliate" status. While the system proposed in this submission would be compatible with changes to the foreign affiliate definition (for example, to require more or less than a 10% ownership stake or to require 10% of votes and value, as in the existing "qualifying interest" test), no such changes are thought to be strictly necessary and it has therefore been assumed that the current definitions of foreign affiliate and controlled foreign affiliate continue to apply.

- Consideration has also been given to further extending the exemption system to Canadian individuals and other direct non-corporate Canadian shareholders of foreign affiliates. The current system provides an exemption from Canadian corporate tax in respect of dividends from foreign affiliates paid to a Canadian corporation out of exempt surplus, but Canadian tax on such foreign-source earnings can still arise at the shareholder level when the Canadian corporate shareholder distributes its profits. If an individual directly held the shares of a foreign affiliate and was exempt from Canadian tax on all dividends paid on the share out of active business earnings, there would be no Canadian tax whatsoever paid on such foreign source earnings. There does not appear to be any compelling tax policy reason to extend the exemption system to individuals and other non-corporate shareholders, and this proposed system accordingly continues the current scope of the exempt surplus rules which are restricted to Canadian corporate shareholders of foreign affiliates.

- Consideration has also been given to extending the exemption system to foreign source business income earned by a Canadian shareholder through a foreign branch, rather than through a foreign affiliate. The current system taxes foreign source branch income under the section 126 foreign tax credit mechanism. This proposed system continues the credit treatment of branch income, consistent with capital export neutrality, and limits the expanded exemption system to foreign source active business income earned through foreign affiliates of Canadian corporate shareholders.

Modified Exempt Surplus Account

- The main advantage of the proposed expansion of the exemption system is that the taxable surplus/deficit account would be eliminated. Foreign affiliates would maintain a single exempt surplus/deficit account in respect of each relevant Canadian corporate shareholder.

- Elimination of the taxable surplus account makes it necessary to carefully assess which particular income items should be included in exempt surplus. In the variation of an expanded exempt surplus system explored in this submission, the exempt surplus of a foreign affiliate in respect of a Canadian corporate shareholder would consist of the following components:

    - net earnings from all active businesses carried on by the foreign affiliate in any country anywhere in the world and regardless of the jurisdiction in which the foreign affiliate is resident (no longer limited to designated treaty countries as in Reg. 5907(1)"exempt earnings"(d)(i), and also TIEA countries);

    - net property income recharacterized as active business income of the foreign affiliate under paragraph 95(2)(a) (same as currently in Reg. 5907(1)"exempt earnings"(d)(ii) but without the requirement that the payor and payee foreign affiliates must be resident in a designated treaty country);

    - dividends (net of foreign withholding tax) received by the foreign affiliate from other foreign affiliates paid out exempt surplus (same as Reg. 5907(1)"exempt surplus"A(iii)); dividends paid by the foreign affiliate would be deducted from exempt surplus as in the current system;

    - gains (net of foreign tax) realized by the foreign affiliate from dispositions to arm's length persons of property used or held by it principally in an active business carried on anywhere in the world (no longer limited to designated treaty countries as in Reg 5907(1)"net earnings"(c) and "exempt earnings"(a)(ii), or to TIEA countries);

  - note that the entire capital gain (net of tax) from *arm's length* dispositions of capital properties used in an active business would be included in exempt surplus; non-arm's length or "internal" dispositions would not give rise to any surplus consequences;

- net earnings from FAPI (i.e., FAPI net of foreign accrual tax (FAT) applicable), but only to the extent that such net FAPI has been imputed to, i.e. already taxed in the hands of, the particular Canadian corporate shareholder under subsection 91(1):

  - As described below under the heading Taxation of Property Income (FAPI and FIE Rules), if the foreign affiliate is a controlled foreign affiliate, FAPI would be imputed under subsection 91(1); since this FAPI income would already have been subject to tax in Canada, it would be added to exempt surplus so that it will be exempt from any additional Canadian tax when it is ultimately repatriated to the Canadian corporate shareholder as a dividend;

  - Consideration has been given to imputing FAPI of all foreign affiliates (i.e., including non-controlled foreign affiliates) under subsection 91(1); this extension of the FAPI rules is not recommended here, in part because of overlap with the proposed FIE rules (modified FIE rules should be adequate to impose current tax on investment income earned in a non-controlled foreign affiliate) and because of the potential information-gathering difficulties where the Canadian taxpayer does not have a controlling interest in the foreign affiliate. However, it is also possible (as many have advocated) that a determination may be made to scale back the proposed FIE rules, in which case it might be appropriate to extend the imputation of FAPI under subsection 91(1), possibly to all foreign affiliates, not only controlled foreign affiliates. In such a scenario, all net earnings from FAPI could be included in exempt surplus to avoid taxing such income a second time upon repatriation;

- Note that where the FAPI arises from a disposition of a capital property that is not excluded property, for instance a foreign affiliate share, the FAPI amount would include only the taxable capital gain. It would therefore be necessary to "gross-up" the exempt surplus inclusion to include also the tax-exempt portion of the capital gain (net of foreign tax), so that the entire capital gain from the non-excluded property disposition would be included in exempt surplus (net of foreign tax), thereby allowing the tax-free repatriation to Canada, out of exempt surplus, of the entire net capital gain amount that was already taxed in Canada under the FAPI rules.

- Similarly, an exempt deficit of a foreign affiliate in respect of a Canadian corporate shareholder would result where the foreign affiliate's losses from the above sources (other than FAPLs) exceed income, in the same manner as in the current system.

- Note that exempt surplus would not include the tax-exempt portion of capital gains from certain capital property dispositions, unlike existing Reg. 5907(1)"exempt earnings"(a). This is intended to retain potential Canadian taxation of capital gains realized by foreign affiliates (other than from arm's length dispositions of active business assets) when the capital gains are eventually distributed to the Canadian corporate shareholder as a pre-acquisition surplus dividend, as described below.

Foreign Affiliate Dividends

- Dividends paid by a foreign affiliate of a Canadian corporate shareholder would be considered to be paid first out of exempt surplus, to the extent of any positive balance of exempt surplus at the time of the dividend payment. Any excess dividend amount, including any dividend paid by a foreign affiliate with an exempt deficit, would be considered paid out of pre-acquisition surplus. These would be effectively the same dividend ordering rules as in Reg. 5901, but disregarding taxable surplus.

- Exempt surplus dividends paid by a foreign affiliate of a Canadian corporate shareholder to another foreign affiliate would increase the exempt surplus (or reduce the exempt deficit) of the recipient foreign affiliate, as in the current system. Pre-acquisition surplus dividends paid by a foreign affiliate to another foreign affiliate would reduce the recipient's adjusted cost base of the shares of the payor foreign affiliate, as in current subsection 92(2). This would be relevant only where the foreign affiliate shares were not excluded property (because in this proposed system gains or losses from excluded property share dispositions are not included in exempt surplus, but rather affect pre-acquisition surplus and are therefore effectively disregarded).

- Exempt surplus dividends paid by a top-tier foreign affiliate to a Canadian corporate shareholder would be included in income under section 90 and then fully deducted, giving rise to the same exemption from Canadian tax as in paragraph 113(1)(a). Pre-acquisition surplus dividends paid by a top-tier foreign affiliate to the Canadian corporate shareholder would also be included in income and then fully deducted, as in current section 90 and paragraph 113(1)(d). However, the Canadian corporate shareholder's adjusted cost base of the top-tier foreign affiliate shares would be reduced by the amount of any paragraph 113(1)(d) deduction (less any foreign withholding tax) as in current subsection 92(2). The recipient Canadian shareholder could potentially realize a capital gain under subsection 40(3) if the adjusted cost base were reduced to a negative amount.

- Any foreign affiliate dividends paid to a non-corporate Canadian shareholder, such as an individual, would be included in income under section 90. As in the current system, there would be no section 113 relief for foreign corporate tax, but the subsection 126(1) foreign tax credit for foreign withholding taxes would remain. A deduction similar to current subsection 91(5) would provide relief to the non-corporate shareholder for previously taxed FAPI (see below under the heading Taxation of Property Income (FAPI and FIE Rules)).

- The foregoing discussion has implicitly assumed ordinary cash dividends paid by foreign affiliates. However, non-cash dividends of in-kind property could be treated in the same conceptual manner as described above, with the amount of such distributions being measured by the fair market value of the distributed property, as in the current rules, as opposed to measuring certain distributions by reference to the cost of the distributed property as under the various February 27, 2004 foreign affiliate distribution and surplus suspension proposals. In short, it would not be necessary to have complex rules to police internal property transfers so as to avoid the "artificial" creation of exempt surplus, because it would not be possible for an internal property transfer to give rise to exempt surplus as it has been defined above for this proposal. Stock dividends could continue to be deemed nil as in current subsection 95(7).

Taxation of Property Income (FAPI and FIE Rules)

- FAPI of a foreign affiliate would be computed essentially as in the current system, to include property income, income from a business other than an active business (thus preserving the current base erosion rules), and taxable capital gains from dispositions of non-excluded property, less any deduction of foreign accrual property loss (FAPL) carryovers of the particular foreign affiliate.

    - FAPLs would continue to be determined on a foreign affiliate specific basis and could be carried over in the same manner as under Reg. 5903 (although a 20-year carryforward period would now be more appropriate to conform to the domestic loss carryforward period).

    - It would be necessary to compute FAPI and FAPLs only for a controlled foreign affiliate of a particular Canadian taxpayer, not for all foreign affiliates as is currently the case, thereby promoting some modest simplification. This is because FAPI earned in a non-controlled foreign affiliate would not be imputed to Canada, it would not be added to exempt surplus, and such earnings would accordingly be added to pre-acquisition surplus and effectively disregarded.

  - The recently enacted TIEA rules which include in FAPI any income from a "non-qualifying business" would be undone, since such active business income would instead be included in exempt surplus.

- FAPI earned by a controlled foreign affiliate of a Canadian taxpayer would be included in income of the Canadian taxpayer on a current basis, in the same participating percentage as under the existing system in subsection 91(1).

  - The Canadian taxpayer would be permitted the same deduction in respect of FAT applicable to the FAPI inclusion as in current subsection 91(4) (although as discussed below, FAT might be expanded to capture foreign withholding taxes as the net FAPI amount is subsequently distributed up the chain to Canada). The effect is to preserve the same current taxation of FAPI earned by a controlled foreign affiliate with an indirect foreign tax credit, as in the current system.

  - If the Canadian taxpayer is a corporation, the net earnings from the FAPI of its controlled foreign affiliate would be added to the exempt surplus of the controlled foreign affiliate, as described above under the heading "Modified Exempt Surplus Account". This is to ensure that no further Canadian tax would result when the net FAPI amount is ultimately distributed to the Canadian corporate shareholder. No addition would need be made to the adjusted cost base of the Canadian corporate shareholder's top-tier foreign affiliate shares, in contrast to current subsection 92(1) (because if the Canadian taxpayer were to sell the shares of the top-tier foreign affiliate before the FAPI had been distributed to it, the gain could be reduced by making a subsection 93(1) election as in the current system and as described below, so as to access the exempt surplus arising from the taxed FAPI).

- Adding the taxed FAPI to the controlled foreign affiliate's exempt surplus would also appropriately allow the taxpayer to reduce the capital gain from a sale of lower-tier, non-excluded property foreign affiliate shares, using a subsection 93(1) election. For instance, in the case of a lower-tier controlled foreign affiliate earning FAPI, it could well be the case that the shares of the controlled foreign affiliate would not constitute excluded property. If those non-excluded property shares were sold such that the vendor foreign affiliate realized a taxable capital gain that would otherwise be included in FAPI, under the proposed system the vendor foreign affiliate would be able to reduce that taxable capital gain by accessing the taxed FAPI (included in exempt surplus) through a subsection 93(1) election. This mechanism to avoid cascading of FAPI taxation would not be available if the taxed FAPI were instead added to the Canadian corporate shareholder's adjusted cost base of its top-tier foreign affiliate shares, as is currently the case under subsection 92(1).

- If the controlled foreign affiliate earning the taxed FAPI had a sufficiently large exempt deficit, treating the taxed FAPI as an addition to exempt surplus would reduce the exempt deficit.

- Since FAPI is and would continue to be taxed under a credit system in subsections 91(1) and (4), a mechanism would be needed to provide further subsection 91(4) deductions in respect of additional foreign withholding taxes relating to taxed subsection 91(1) FAPI amounts, which foreign withholding taxes might be incurred in subsequent years as the net FAPI is distributed up the chain to the Canadian taxpayer. This is one of the advantages of the current, but more complex, foreign affiliate system in which separate taxable surplus and underlying foreign tax accounts are maintained. In the current system, these additional foreign withholding taxes relating to taxed FAPI are added to underlying foreign tax and are effectively credited by virtue of the paragraph 113(1)(b) deduction or the subsection 91(5) deduction when the FAPI is ultimately repatriated to Canada. It would be undesirable to sacrifice the simplicity of the expanded exemption system by requiring replication of a taxable surplus-type account for the taxed FAPI that is added to exempt surplus, and yet appropriate crediting requires relief for foreign withholding taxes subsequently imposed on subsection 91(1) FAPI amounts as they are distributed up the chain (as exempt surplus, in this suggested system). Perhaps the solution lies in a broadened wording of subsection 91(4) that would allow future deductions, in aggregate not exceeding prior subsection 91(1) inclusions, to the extent that the taxpayer establishes that foreign withholding tax on exempt surplus dividends is traceable or related to the net FAPI amounts previously taxed under subsection 91(1). Any such additional subsection 91(4) deductions would then also need to be deducted from the exempt surplus account of the relevant foreign affiliate.

- If the Canadian taxpayer is an individual or other non-corporate taxpayer, there would be no exempt surplus balance for the controlled foreign affiliate in respect of the Canadian taxpayer. Accordingly, the net FAPI income inclusion (subsection 91(1) net of subsection 91(4) FAT deduction) would be added to the adjusted cost base of the Canadian taxpayer's top-tier foreign affiliate shares, in the same manner as in current subsection 92(1).

- Upon payment of a dividend on the top-tier foreign affiliate shares resulting in a section 90 income inclusion for the non-corporate Canadian shareholder, a deduction analogous to subsection 91(5) would be permitted, equal to the lesser of the section 90 dividend and the prior increase in adjusted cost base of the top-tier shares resulting from prior net FAPI inclusions. The non-corporate shareholder's adjusted cost base of the top-tier foreign affiliate shares would then be reduced to reflect the subsection 91(5) deduction, as in current paragraph 92(1)(b).

- The effect of this mechanism would be to treat foreign affiliate dividends paid to non-corporate Canadian shareholders as being paid first out of previously taxed FAPI, resulting in a net section 90 income inclusion only to the extent the dividend exceeds previously taxed FAPI.

- FAPI earned by a foreign affiliate that is not a controlled foreign affiliate would not be imputed to and taxed currently in the hands of the Canadian shareholder, similar to the current system. As a result, the FAPI earned by the foreign affiliate would not be included in its exempt surplus account, nor would it be added to the Canadian shareholder's adjusted cost base of its top-tier foreign affiliate shares. Consequently, detailed calculations of such FAPI or FAPLs of a non-controlled foreign affiliate would not be necessary -- such amounts would simply be excluded from the exempt surplus and deficit calculations and would effectively become part of the foreign affiliate's pre-acquisition surplus.

- Note that property income of a non-controlled foreign affiliate could nonetheless indirectly be brought into income of the ultimate Canadian shareholder under the proposed FIE rules in sections 94.1 to 94.4. This would be the case if, among other things, more than 50% of the foreign affiliate's property (based on carrying value) is investment property, or if the foreign affiliate's principal undertaking is an investment business, and the foreign affiliate shares do not constitute an exempt interest.

    - Note also that the degree to which non-controlled foreign affiliate shareholdings are captured by the FIE rules will depend on how strictly "qualifying entity" is defined in proposed subsection 94.1(1), for purposes of subsection 94.1(1)"exempt interest"(a)(ii). For example, it might be appropriate to tighten the qualifying entity requirements or even to eliminate altogether this part of the exempt interest definition, so as to clearly bring non-controlled foreign affiliate shares within the FIE rules where the relevant assets/businesses are of a principally non-active character. This would facilitate the integration of the FIE rules with the proposed expanded exemption system.

    - It would also be appropriate to preserve the proposed mechanism in paragraph 94.1(2)(h) to permit taxpayers owning certain FIEs that are not controlled foreign affiliates to elect to treat such FIEs as if they were controlled foreign affiliates. Simplification of the FIE rules might in many cases be enhanced if taxpayers could "opt in" to the FAPI rules for taxing property income of non-controlled foreign affiliates.

- Further simplification of the FIE rules might be possible by using the exempt surplus account of a foreign affiliate as the way in which to prevent double taxation when the FIE rules apply. For example, if a non-controlled foreign affiliate is determined to be a FIE and the Canadian (corporate) shareholder has an income inclusion under the imputed income regime in subsection 94.1(4), the income inclusion amount could be added to the foreign affiliate's exempt surplus, in the same manner as is proposed for net FAPI inclusions for controlled foreign affiliates.

- If FAPI earned by non-controlled foreign affiliates was not taxed under the overriding FIE rules, it would effectively be treated as pre-acquisition surplus. Such FAPI would accordingly not be taxed in Canada unless and until the Canadian shareholder disposes of its top-tier foreign affiliate shares and realizes a capital gain (or, if the non-controlled foreign affiliate shares are not excluded property and are owned by a controlled foreign affiliate of the Canadian taxpayer, upon a disposition of those non-excluded property shares), or distributions are made to the Canadian shareholder that exceed the aggregate of the exempt surplus and adjusted cost base of the top-tier shares (since distributions exceeding this amount would drive the adjusted cost base negative triggering a subsection 40(3) capital gain). In either case the FAPI would effectively be taxed only on a capital gains basis, i.e., only 50% of the property income would ever potentially be taxed in Canada. Thus in this sense, unless simplicity is sacrificed to maintain a separate FAPI balance account (which in effect means retaining a taxable surplus account), the eventual Canadian taxation of such FAPI would potentially be deferred to a greater extent than under the current system and the effective tax rate would be lower than is currently the case.

- The deferred (and reduced rate) taxation of FAPI earned by a non-controlled foreign affiliate could further justify the more direct application of the FIE rules to all non-controlled foreign affiliate circumstances as suggested above.

- In addition, with enhanced FIE rules applying directly to non-controlled foreign affiliates, the most egregious taxpayer attempts to convert property income into capital gains income under this proposed system would be captured by the FIE rules. The only property income earned in a non-controlled foreign affiliate that would ultimately be taxed in Canada at a capital gains rate would be "incidental" property income that was not earned in a FIE and escaped taxation under the enhanced FIE rules.

Foreign Affiliate Share Dispositions (Section 93 Elections)

- The Consultation Report raises the issue whether, in an expanded exemption system, it is also appropriate to continue to tax capital gains from dispositions of shares of foreign affiliates. An alternative would be to adopt a "participation exemption" that would exempt from tax capital gains realized by foreign affiliates and their Canadian shareholders from dispositions of foreign affiliate shares. However, the proposed system in this submission does not adopt such an extension of the exemption system. In this proposed system, the exemption is available for all active business income earned by foreign affiliates, but capital gains from foreign affiliate share dispositions are treated as equivalent to investment income and not as business income, and are accordingly retained within the Canadian tax net.

- In particular, it is proposed to maintain the current taxability of capital gains realized by a Canadian shareholder from dispositions of top-tier foreign affiliate shares. For lower-tier dispositions of foreign affiliate shares by a foreign affiliate vendor, it is proposed also to potentially tax the capital gain, but the timing of such taxation would depend on the excluded property status of the shares, as in the current system. For lower-tier non-excluded property foreign affiliate share dispositions, the taxable capital gain would be included in FAPI, resulting in a subsection 91(1) income inclusion for the Canadian taxpayer if the selling foreign affiliate is a controlled foreign affiliate. In any other case (i.e, if the shares are excluded property, or if the vendor is a non-controlled foreign affiliate), there would be no immediate imputation of the taxable capital gain, but neither would there be any amount added to exempt surplus of the selling foreign affiliate in respect of the capital gain. The effect of this proposed mechanism is that when the Canadian taxpayer finally exits from the foreign investment by causing the sale proceeds to be distributed to it, the foreign affiliates's capital gain will effectively be treated as a pre-acquisition surplus dividend, reducing the Canadian taxpayer's adjusted cost base of its top-tier foreign affiliate shares, and potentially triggering a capital gain under subsection 40(3) if and to the extent the adjusted cost is reduced to a negative amount.

- It might be argued that there is an apparent contradiction in a system that would provide a full Canadian tax exemption for dividends paid from a foreign affiliate out of active business earnings, but that would at the same time tax capital gains realized by the Canadian shareholder upon disposition of the foreign affiliate shares, even where the gain is attributable to appreciation in an active business carried on by the foreign affiliate.

- However, as noted above, the exemption system is conceived as an exemption for active business earnings, not for property income. Capital gains income, even where the gain is attributable to the value of an active business, is more akin to passive property or investment income rather than active business income. For instance, this dichotomy is already embodied in the ITA with respect to Canadian-source active business earnings of a CCPC, which are taxed at a preferential small business deduction rate in subsection 125(1.1), in contrast to taxable capital gains realized by a CCPC from dispositions of shares (including shares of a CCPC carrying on an active business in Canada) which gains are included in "aggregate investment income" in subsection 129(4).

- In a similar vein, the principal rationale for the exemption for dividends is to avoid double tax, because the income from which the dividends are paid will (at least in most cases) already have been subject to foreign income taxation levied against the foreign affiliate which generated the underlying earnings. The Canadian exemption acknowledges that the source country has the primary, indeed the exclusive, jurisdiction to tax the active business income that is sourced outside Canada. In contrast, where a Canadian shareholder realizes a capital gain from the disposition of foreign affiliate shares, the source of the income is arguably Canadian, at least in the sense that the property giving rise to the gain is held directly by the Canadian-resident taxpayer. In circumstances where the foreign country in which the foreign affiliate is constituted claims the jurisdiction to tax the gain realized by the Canadian resident from a disposition of that foreign affiliate's shares, that claim is frequently overridden by one of Canada's tax treaties allocating the taxing jurisdiction to Canada as the residence country (particularly if the value of the foreign affiliate shares is not attributable to real or immoveable property located in the relevant foreign country); even if the foreign country retains the jurisdiction to tax the gain, double taxation is effectively avoided through Canada's existing section 126 foreign tax credit mechanism.

- In other words, Canada has a stronger claim to tax a capital gain realized directly by a Canadian owner of foreign affiliate shares, and an outright exemption is not required to avoid double taxation of that gain. The existing tax treaty system generally recognizes Canada's jurisdiction to tax capital gains from top-tier foreign affiliate share dispositions (except where value is derived from immoveable property). Retention of potential Canadian taxation of capital gains from dispositions of top-tier and lower-tier foreign affiliate shares could be said to promote capital export neutrality with respect to this source of investment income.

- In addition, in the expanded exemption system that is described in this submission, as a practical matter it is desirable to preserve Canada's ability to tax the Canadian shareholder on capital gains realized from dispositions of the top-tier foreign affiliate shares, because that is the "fallback" mechanism, apart from the FIE rules, by which FAPI realized by non-controlled foreign affiliates would ultimately be taxed in Canada. Such capital gains taxation is also relevant to liquidations of top-tier foreign affiliates as described under the heading "Further Observations" below.

- A mechanism similar to the existing subsection 93(1) election would permit reduction of capital gains from foreign affiliate share dispositions that are attributable to undistributed active business earnings or to pre-taxed FAPI.

  - The subsection 93(1) election could be elective in the case of both a lower-tier sale of foreign affiliate shares by another foreign affiliate (unlike the mandatory election proposed in the February 27, 2004 amendments), and also in the case of a sale of foreign affiliate shares by a Canadian corporate shareholder, as under the current rule. The only circumstance where a section 93 election would be relevant for lower-tier foreign affiliate share dispositions would be where the shares are not excluded property and the FAPI gain could be reduced by underlying exempt surplus. Making the election truly elective would minimize the circumstances where the surplus consequences would need to be determined, thereby promoting simplicity.

  - Exempt surplus of a foreign affiliate potentially accessible under a section 93 election could be computed on a consolidated basis similar to the February 27, 2004 proposals. This would ensure that exempt deficits in the underlying foreign affiliate group are properly taken into account, as intended by those proposals. However, the calculation of consolidated exempt surplus, and the corresponding group surplus adjustments, would be considerably simplified by virtue of the elimination of the taxable surplus/deficit accounts.

- Consideration has been given to the incentive effects of the foregoing capital gains mechanisms and the likely response of taxpayers seeking to exit from their foreign affiliate investments. Clearly, if Canadian taxpayers continue to be subject to capital gains taxation upon sale of directly held foreign affiliate shares (i.e., if no full participation exemption is instituted), then if the gain cannot reduced to nil by accessing underlying exempt surplus pursuant to a subsection 93(1) election, in some cases the optimal strategy may be to effect a sale of lower-tier foreign affiliate shares.

    - If the foreign affiliate shares are excluded property, the capital gain resulting from a lower-tier sale would not give rise to immediate Canadian taxation; Canadian tax would be deferred until the sale proceeds are fully distributed to Canada. Recall that the none of the capital gain from the disposition of the excluded property shares would be included in the vendor foreign affiliate's exempt surplus balance. The distribution of the capital gain would effectively result in a pre-acquisition surplus dividend, which would reduce the Canadian taxpayer's adjusted cost base of its top-tier foreign affiliate shares, potentially giving rise to a subsection 40(3) capital gain. Thus, the lower-tier foreign affiliate share sale could defer the Canadian tax but not if the sale proceeds are fully distributed to Canada and exceed the top-tier adjusted cost base.

    - In contrast, if the foreign affiliate shares are not excluded property, a Canadian taxpayer could not escape Canadian taxation of the capital gain simply by transferring the shares into a holding company foreign affiliate and causing the sale to be made by that vendor, because the capital gain would be FAPI that would be imputed to the Canadian shareholder, assuming the holding company is a controlled foreign affiliate. If the holding company were not a controlled foreign affiliate there would be no attribution of FAPI, but neither would the capital gain trigger any exempt surplus, so that upon distribution by the holding company of the sales proceeds, the capital gain portion would result in a pre-acquisition surplus dividend potentially taxable under subsection 40(3).

- In either case, such a foreign affiliate holding structure would be effective only if established in the absence of a contemplated sale, since a modified subsection 85.1(4) (amended to apply to transfers of both excluded property and non-excluded property foreign affiliate shares as part of the series of transactions that includes the arm's length sale of those shares) could restrict the Canadian taxpayer from transferring the shares to be disposed of into a holding company foreign affiliate on a tax-deferred rollover basis in contemplation of the sale.

Further Observations

- As noted above, the preservation of Canadian capital gains tax in respect of top-tier foreign affiliate share dispositions is the key mechanism by which Canadian tax is ultimately imposed on distributions of non-imputed FAPI (i.e., FAPI earned by a non-controlled foreign affiliate that is not captured by enhanced FIE rules), and distributions of capital gains realized by foreign affiliates from sales of lower-tier foreign affiliate shares. Neither of these income sources results in any imputation of income under subsection 91(1), but neither do they give rise to any exempt surplus. Accordingly, when such amounts are distributed they are effectively treated as pre-acquisition surplus dividends, which is effectively equivalent from a tax perspective to a capital reduction. No Canadian tax would result until the amount of all such pre-acquisition surplus distributions was sufficient to fully deplete the Canadian taxpayer's adjusted cost base in its top-tier foreign affiliate shares and reduce it to a negative amount, triggering a capital gain under subsection 40(3). Thus, the possibility of Canadian tax of such FAPI and capital gains would be preserved, although it would be possible for a taxpayer to defer Canadian tax indefinitely simply by not causing the distribution of such amounts to Canada. This deferral is equally possible under the current system (such amounts would give rise to taxable surplus), with the difference that under the proposed system distributions could be made to Canada without Canadian tax until the adjusted cost base of the top-tier foreign affiliate shares was fully depleted. In other words the proposed system provides a longer possible deferral of Canadian tax, and in this sense may be said to promote capital import neutrality to a greater extent than the current system.

- Similarly, in this proposed system the treatment of top-tier foreign affiliate liquidations could be substantially simplified, with most of the proposed amendments to subsection 88(3) from the February 27, 2004 proposals, and their subsequent modifications, becoming irrelevant. Effectively the current subsection 88(3) rollover could be preserved for distributions of foreign affiliate shares made on the liquidation of a top-tier foreign affiliate (not restricted to a liquidation of a controlled foreign affiliate as under the current rule). This would mean that Canadian taxpayers would potentially realize capital gains to the extent the non-share consideration distributed to them (plus the adjusted cost base of foreign affiliate shares distributed on a rollover basis) exceeds their adjusted cost base of the shares of the liquidating foreign affiliate, as under the current rule, with the possibility of reducing that capital gain by accessing underlying exempt surplus through a subsection 93(1) election. This would be an appropriate result in a system that is intended to impose Canadian capital gains tax upon a taxpayer's final exit from a foreign affiliate investment. If the gain is attributable to amounts other than active business income or taxed FAPI included in exempt surplus (for example, if the gain is attributable to FAPI earned in a non-controlled foreign affiliate, or to capital gains realized from prior dispositions of excluded property other than active business assets), then it is arguably appropriate for Canadian capital gains tax to be levied at that time of final realization of the foreign affiliate investment. The continued rollover for distributions of foreign affiliate shares is justified on the basis that the Canadian taxpayer would not have fully realized its investment in the liquidating foreign affiliate to the extent that those shares are exchanged for other foreign affiliate shares on the liquidation.

- Moreover, the complex surplus suspension proposals from the February 27, 2004 draft legislation would be unnecessary in this proposed system. These surplus suspension proposals are generally intended to prevent the artificial creation of exempt surplus from internal or non-arm's length dispositions of excluded property. However, by eliminating the taxable surplus account, and by defining exempt surplus in a manner that does not permit exempt surplus to arise from an internal disposition of excluded property, there would no longer be any requirement to override the deemed fair market value (under subsection 69(1)) internal transfer of excluded property. Foreign affiliate rollovers would still be required for mergers, liquidations and other share exchanges that do not result in a realization of the taxpayer's investment for non-share consideration, but the relevance of these rollovers would be restricted to circumstances where the property disposed of is not excluded property, and only where the non-excluded property is held through a controlled foreign affiliate. In other words, the existing rollovers could be targeted specifically to share exchange transactions that would otherwise give rise to FAPI in a controlled foreign affiliate.

- Transition to a simplified and expanded exemption system as proposed in this submission would need to take into account existing taxable surplus and underlying foreign tax balances. One possibility would measure each foreign affiliate's "net taxable surplus", namely its taxable surplus net of underlying foreign tax grossed up by the appropriate relevant tax factor. This amount would represent the net amount of the taxable surplus that would be included in income if distributed to the Canadian parent under the current system, and could accordingly be deducted from the foreign affiliate's exempt surplus balance. The effect of grinding exempt surplus by the foreign affiliate's "net taxable surplus" (and possibly creating an exempt deficit) is to treat the net taxable surplus amount as pre-acquisition surplus that would be taxed as a capital gain if and when it is ultimately repatriated to Canada and the taxpayer's adjusted cost base of its top-tier foreign affiliate shares is fully depleted.

- A logical extension of an expanded exemption system for dividends paid out of foreign-source active business income would apply the same exemption principle to other means of repatriating foreign-source active business income to Canada, such as interest and royalty payments, for example. To a large extent, where a Canadian parent company intends to cause its foreign affiliate to repatriate funds to Canada, apart from tax treatment, the income streams from dividends, interest and royalties would effectively be substitutable. From a policy perspective, subparagraph 95(2)(a)(ii) already embodies the consolidation principle, such that if a payment is deductible in computing the exempt surplus of the payor foreign affiliate, it should be included in the exempt surplus of the payee foreign affiliate. In this context, it does not seem to be a large leap to extend that principle to circumstances where the payee is the Canadian-resident parent corporation. A payment made to a foreign affiliate that qualifies for subparagraph 95(2)(a)(ii) relief would add to exempt surplus and would accordingly not ever be taxed in Canada – so it would similarly be appropriate to allow the payment to be made directly to the Canadian taxpayer and permit the same relief.

- As a final comment, it is observed that the expanded exemption system proposed in this submission could arguably be compatible with any outcome of the debate concerning the deductibility of interest on funds borrowed by a Canadian taxpayer and used to purchase shares of or otherwise invest in a foreign affiliate. On the one hand, it could be argued that in an expanded exemption system where no Canadian tax is imposed on foreign-source active business earnings, there is little justification for a continued interest deduction because the income earned with the borrowed funds will ultimately be exempt from tax. On the other hand, this argument could be flipped on its head, since in the proposed exemption system outlined in this submission, capital gains taxation of the top-tier foreign affiliate shares is retained, effectively as a proxy for property and capital gains income earned in the foreign affiliate group – thus a continued non-exempt income-earning purpose could be shown that could justify continued interest deductibility. Perhaps a middle ground that might more specifically target the tax policy objective, and also promote the competitiveness of Canadian-based taxpayers investing outside Canada, would permanently allow interest deductions on funds borrowed to invest in foreign affiliates, but as dividends are paid on the top-tier foreign affiliate shares, the portion of those dividends qualifying as exempt surplus dividends could be reduced to the extent of the prior interest deductions. In other words, the otherwise available paragraph 113(1)(a) deductions could be clawed back to the extent interest has previously been deducted on funds borrowed to purchase shares of or invest in the foreign affiliate that paid the dividend, so that dividends that otherwise would be considered paid out of exempt surplus would instead be considered paid out of pre-acquisition surplus. This would be substantially more generous than the original interest deduction denial proposed in the March 19, 2007 federal budget, because in that proposal the interest deduction would have been initially denied, creating a disallowed interest pool from which deductions would be allowed only when and to the extent that non-exempt income was earned from the foreign affiliate investment. Moreover, adoption of this possible alternative could substitute for, and allow the repeal of, recently enacted section 18.2.

Summary

This submission strongly supports the extension of full exemption treatment to all active business income earned by foreign affiliates anywhere in the world and without requiring that they be resident in a designated treaty country or TIEA country. However, this submission has assumed that foreign affiliate share dispositions would continue to be subject to capital gains taxation, and does not advocate for a more "revolutionary" participation exemption system. Given the continued importance of capital gains taxation in such a system, the key features to make an expanded exemption system operate properly are the components of exempt surplus, and the manner in which the FAPI and FIE rules overlap to tax investment income, particularly in non-controlled foreign affiliates. This submission has proposed and explored a number of design features for a possible exemption system that would permit substantial simplification of the current foreign affiliate system, yet would retain many of the principal characteristics of the current system. While many other possible specific designs could feasibly implement the general objective of expanding the exemption system for foreign affiliate business income, it is hoped that this submission has demonstrated that at least one such specific alternative could be made to operate practically, coherently, and with fewer compliance burdens than the current system.

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