EXPLANATORY NOTES - FOREIGN AFFILIATE AMENDMENTS

Overview

Various provisions of the *Income Tax Act* (the "Act") and *Income Tax Regulations* (the "Regulations") that deal with foreign affiliates of taxpayers resident in Canada are being amended or repealed, and some new provisions are being added. Most of these provisions deal with sales and reorganizations of, and distributions from, foreign affiliates and represent revisions to those aspects of proposals previously released on February 27, 2004 (the "2004 Proposals") that have not yet been finalized. The following provisions are included in this legislative package:

1. **Hybrid Surplus:** This package of amendments introduces a new category of surplus called "hybrid surplus". (This term and related terms are defined in subsection 5907(1) of the Regulations.) As its name suggests, "hybrid surplus" is a hybrid of exempt and taxable surplus in that one half of any distributions from hybrid surplus is exempt and the other half is taxable, with allowance for a deduction reflecting grossed-up underlying taxes. Hybrid surplus is the replacement for a regime, proposed as part of the 2004 Proposals, of gain suspension in respect of internal transfers of shares of foreign affiliates. Hybrid surplus will generally capture 100% of any gains from the sale of shares of a foreign affiliate by another foreign affiliate. This contrasts with the currently-enacted rules which classify one half of such gains as exempt surplus and the other half as taxable surplus. Essentially, hybrid surplus retains that principle but requires the two surplus pools to be distributed together.

2. **Upstream Loans:** This package introduces a new "upstream loan" rule to protect the integrity of the existing taxable surplus and the new hybrid surplus regimes. This rule is modelled on existing subsection 15(2) of the Act and is found in new subsections 90(4) to (10) of the Act. This new rule generally provides for an inclusion in the income of a taxpayer resident in Canada where loans are made by foreign affiliates of the taxpayer to certain "specified debtors" and the loans remain outstanding for more than 2 years.

3. **Reorganizations:** This package amends various provisions of the Act and Regulations that deal with liquidations and dissolutions of foreign affiliates as well as mergers or combinations of foreign affiliates. These amendments are in part based on the 2004 Proposals and in part on comfort letters issued in respect of those proposals. Amendments are also being made to certain share-for-share exchange provisions involving foreign affiliates in order to prevent the transfer and duplication of losses.

4. **Return of Capital:** This package also replaces proposals made in the 2004 Proposals, and subsequently refined by way of comfort letters, dealing with distributions of capital from a foreign affiliate. The new proposals make the concept of capital of a

foreign affiliate irrelevant and treat most distributions in respect of the shares of a foreign affiliate as dividends. However, taxpayers will be able to elect, in most circumstances, to ignore the normal surplus ordering rules and instead have dividends paid by a foreign affiliate deemed to be paid out of pre-acquisition surplus. Since pre-acquisition surplus dividends are fully deductible from taxable income and reduce the adjusted cost base ("ACB") of a foreign affiliate's shares, this new regime will have the effect of allowing taxpayers to access the ACB of the shares of their foreign affiliates as a surrogate for the capital of their foreign affiliates.

5. **Surplus Reclassification:** This package also contains a new anti-avoidance rule (in subsection 5907(2.02) of the Regulations) that reclassifies certain amounts from exempt to taxable surplus where the amounts arise from transactions that are avoidance transactions, within the meaning of subsection 245(3) of the Act. This new rule replaces a suspension regime in respect of certain internal transfers of property (other than foreign affiliate shares) that was proposed as part of the 2004 Proposals.

6. **Stop-Loss Rules:** This package contains revisions to the proposals announced as part of the 2004 Proposals that deal with the foreign affiliate "stop-loss" rules found in current subsections 93(2) to (2.3) of the Act. In addition to improving certain of the formulas in the 2004 Proposals, these amendments take a more focussed approach as to the relief granted. Amendments are also being made to various other stop-loss rules to prevent them from applying to dispositions of excluded property by a foreign affiliate and to ensure that suspended losses from non-excluded property dispositions are released at appropriate times.

7. **FAPI Capital Losses:** This package includes new rules to prevent capital losses of a foreign affiliate from dispositions of non-excluded property from being deducted against ordinary FAPI income. As is currently the case for Canadian corporations, the FAPI capital losses of a foreign affiliate will now only be deductible against the FAPI capital gains of the affiliate.

8. **Safe Income:** This package includes amendments to the so-called "safe income" rules in section 55 of the Act in respect of the surplus of a foreign affiliate. These amendments ensure that appropriate amounts in respect of foreign affiliates are counted towards the safe income of a relevant Canadian corporation.

9. **Surplus Entitlement Percentage:** This package contains revisions to certain interpretive rules in respect of "surplus entitlement percentage", as defined in subsection 5905(13) of the Regulations, as well as related rules found in sections 5902 and 5904 of the Regulations. These amendments deal with so-called "circular" shareholdings as well as situations where a foreign affiliate group has no net surplus.

10. **Absorptive Mergers:** This package includes a new rule to clarify that certain U.S.-style absorptive mergers will qualify for certain foreign affiliate rollover provisions in respect of mergers. This rule is found in new subsection 95(4.2) of the Act.

11. **Immigration:** This package includes revisions to the 2004 Proposals that deal with foreign affiliates that immigrate to Canada. These provisions are found in subsections 5907(13) to (15) of the Regulations.

12. **Insurance Businesses and Fresh Start**: This package includes revisions to the 2004 Proposals that deal with the FAPI computation of policy reserves of an insurance business and the so-called "fresh start" FAPI rules.

13. **Computation of Income, Gains and Losses**: This package contains revisions to the rules in paragraphs 95(2)(*f*) to (*f.15*) of the Act for computing income, gains and losses of a foreign affiliate to deal with gains and losses in respect of debts owing by a foreign affiliate. As part of this initiative, amendments are also being made to subsection 39(2) of the Act.

For details of all provisions included in this legislative package, refer to the notes below under the relevant headings.

This legislative package represents the Department of Finance's final tranche of revisions to the 2004 Proposals. As such, it is notable that the following provisions that were introduced as part of the 2004 Proposals are being abandoned:

- The concept of a special foreign affiliate paid-up capital or "FPUC" (previously proposed in paragraph 88(3)(*e*) and refined in subsequent comfort letters);

- The suspension of gains from the disposition of excluded property (previously proposed in the paragraph (*c.1*) and (*f.3*) series of proposals in subsection 95(2));

- The deemed cost rules for non-resident corporations that become foreign affiliates (previously proposed in paragraphs (*f.91*) to (*f.93*) of subsection 95(2));

- The suspension of losses from the disposition of non-excluded property (previously proposed in the paragraph (*h*) series of proposals in subsection 95(2)); and

- The so-called "reverse fresh start" rules (previously proposed in paragraphs (*k.2*) and (*k.3*) of subsection 95(2)).

Income Tax Act

Clause 1

Loss on certain transfers

ITA
13(21.2)

Subsection 13(21.2) of the Act defers, in certain circumstances, the realization of a loss that would otherwise arise from the disposition, by a person or partnership (referred to in this commentary as the "transferor"), of a depreciable property. The subsection applies where the transferor or a person affiliated with the transferor holds the disposed property, or has a right to acquire it, 30 days after the disposition. Until the earliest of certain so-called "release events" described in the subsection occurs, the transferor is treated as holding a notional depreciable property the capital cost of which is, in effect, the amount of the deferred loss.

The subsection is amended so that – for the purposes of computing a foreign affiliate's exempt surplus or deficit and taxable surplus or deficit in respect of a taxpayer, where the transferor is the affiliate, or a partnership of which the affiliate is a member – the subsection does not apply to a disposition of depreciable property that is "excluded property" (within the meaning assigned by subsection 95(1)) of the transferor. This amendment is intended to ensure that the rule in subsection 13(21.2) is not used for planning purposes to defer losses on excluded property and, thus, to increase exempt or taxable surplus amounts or reduce exempt or taxable deficit amounts.

Similar amendments are being made to carve-out excluded property dispositions from the loss denial rules in paragraphs 14(12)(*a*), 18(13)(*a*), 40(2)(*e.1*), (*e.2*) and (*g*), 40(3.3)(*a*) and subsections 40(3.6) and 93(4).

One of the release events in subsection 13(21.2) is the wind-up release event, i.e., where the transferor is a corporation, a wind-up of the transferor (other than a wind-up under subsection 88(1)). Wind-ups under subsection 88(1) do not qualify as a release event because transfers of assets on such wind-ups take place on a rollover basis. Subsection 13(21.2) is also amended so that the wording of the wind-up release event in the subsection takes into account a transferor that is a foreign affiliate of a taxpayer and, in the foreign affiliate context, qualifying liquidations and dissolutions (or QLADs) and designated liquidations and dissolutions (or DLADs) within the meaning of the new definitions in subsections 88(3.1) and 95(1), respectively, which are wind-ups that take place on a rollover basis. This amendment ensures that, where the transferor is a foreign affiliate of the taxpayer, or a partnership of which such an affiliate is a member, for the purposes of computing the transferor's foreign accrual property income and consequential surplus balances, a wind-up release event in subsection 13(21.2) occurs when the liquidation and dissolution of the transferor begins, unless the liquidation and dissolution is a QLAD or DLAD of the transferor.

Similar QLAD and DLAD provisions are being added to paragraph 14(12)(*g*) and subparagraphs 18(15)(*b*)(iv) and 40(3.4)(*b*)(v).

The first-mentioned amendment applies to dispositions that occur after Announcement Date.

The second-mentioned amendment applies to wind-ups and liquidations and dissolutions that begin after Announcement Date.

Clause 2

Loss on certain transfers

ITA
14(12)

Subsection 14(12) of the Act is a loss denial rule that is analogous to the one in subsection 13(21.2), except that it deals with eligible capital property.

The amendments to subsection 14(12) are similar to those discussed above under subsection 13(21.2) and readers are referred to the commentary under the latter subsection for more details.

The amendment to paragraph 14(12)(*a*) applies to dispositions that occur after Announcement Date.

The amendment to paragraph 14(12)(*g*) applies to wind-ups and liquidations and dissolutions that begin after Announcement Date.

Clause 3

Loss on certain properties

ITA
18(13) and (15)

Subsections 18(13) and (15) of the Act contain a loss denial rule that is analogous to the one in subsection 13(21.2), except that they deal with property dispositions made by a money lender.

The amendments to subsection 18(13) and (15) are similar to those discussed above under subsection 13(21.2) and readers are referred to the commentary under the latter subsection for more details.

The amendment to paragraph 18(13)(*a*) applies to dispositions that occur after Announcement Date.

The amendment to subparagraph 18(15)(*b*)(iv) applies to wind-ups and liquidations and dissolutions that begin after Announcement Date.

Clause 4

Deductions under subdivision i

ITA
20(13)

Subsection 20(13) of the Act provides that, in computing the income for a taxation year of a taxpayer resident in Canada, there may be deducted such amount in respect of a dividend received by the taxpayer in the year on a share owned by the taxpayer of the capital stock of a foreign affiliate of the taxpayer as is provided by subdivision i of Division B of Part I of the Act.

This subsection is being amended to instead provide that, in computing the income for a taxation year of a taxpayer resident in Canada, there may be deducted such amounts as are provided by subdivision i. This amendment is being made to ensure that deductions provided for in that subdivision that are not tied to dividends, for example deductions under subsection 91(4) and new subsections 90(6) and (9), are included in section 20. An analogous amendment in respect of amounts required by subdivision i to be included in a taxpayer's income was recently made to paragraph 12(1)(*k*) of the Act.

This amendment applies to taxation years that end after 1994.

Clause 5

Foreign currency dispositions by an individual

ITA
39(1.1)

New subsection 39(1.1) of the Act is being added consequential to the removal from subsection 39(2) of the rule that reduces the net amount of an individual's gains and losses for a taxation year from certain foreign currency fluctuations by $200. As noted below, subsection 39(2) will now apply only to foreign currency debt owing by a taxpayer and not to dispositions of currency (i.e. money). Since the intent of the $200 carve-out rule for individuals was to provide a *de minimis* amount in respect of holdings of foreign currency, this objective will now be better achieved through a separate rule that contemplates only foreign exchange capital gains and losses from dispositions of foreign currency. New subsection 39(1.1) also ensures that this carve-out rule does not apply to trusts.

Subsection 39(1.1) applies to gains made and losses sustained in taxation years that begin after Announcement Date.

Capital gains and losses from foreign currency debt

ITA
39(2)

Subsection 39(2) of the Act currently applies in circumstances where a taxpayer makes a gain or sustains a loss in a taxation year from foreign exchange fluctuations. This provision, which only applies to gains and losses that are on capital account, deems the net amount of all such gains and losses to be a capital gain or loss for the year from a disposition of currency of a country other than Canada. In the case of taxpayers that are individuals, there is a $200 *de minimis* carve-out applicable for each year.

Subsection 39(2) is being amended in the following ways:

First, it will now apply only to foreign currency debt owing by a taxpayer. “Foreign currency debt” is defined in subsection 111(8) of the Act (and made applicable throughout the Act by subsection 248(1)) to be a debt obligation that is denominated in a currency of a country other than Canada. Thus, foreign exchange gains and losses in respect of asset dispositions, including dispositions of foreign currency, will now be determined (subject to, in the case of individuals other than trusts, new subsection 39(1.1) – as discussed above) exclusively under subsection 39(1). Also, amended subsection 39(2) will have no application to foreign exchange gains made, or losses sustained, by a corporate taxpayer in respect of shares issued by the corporation.

Second, it will no longer combine all foreign exchange gains and losses into one net amount of capital gain or loss for the year. Instead, amended subsection 39(2) creates a separate capital gain or loss from the disposition of currency, other than Canadian currency, for each gain made or loss incurred. This amendment will facilitate the application of the foreign affiliate “carve-out” rule in paragraph 95(2)(*f.1*) of the Act to such capital gains and losses. In this regard, readers should also refer to the commentary below discussing the amendments to paragraphs 95(2)(*f.11*) to (*f.15*) of the Act.

Third, the $200 carve-out rule for individuals is being removed from subsection 39(2). In its place, new subsection 39(1.1) is being added. For more details, refer to the above commentary for that new subsection.

Fourth, certain non-substantive language changes are being made to modernize and clarify the provision.

Amended subsection 39(2) applies in respect of gains made and losses sustained in taxation years that begin after Announcement Date, except where it applies to a foreign affiliate in which case it applies to foreign affiliate taxation years that end after Announcement Date.

Clause 6

Limitations

ITA
40(2)

Subsection 40(2) of the Act sets out various limitations for the general gain and loss computation rules in subsection 40(1) of the Act.

ITA
40(2)(*e.1*) to (*e.3*) and (*g*)

Paragraphs 40(2)(*e.1*), (*e.2*) and (*g*) of the Act limit in certain circumstances a taxpayer's loss from a disposition of certain capital property.

These paragraphs are being amended, and a new paragraph 40(2)(*e.3*) is being added, to carve-out from these provisions excluded property dispositions by a foreign affiliate. These amendments are similar to the first amendment discussed under subsection 13(21.2) above, and readers are referred to the commentary on that subsection for more information.

These amendments apply to dispositions that occur after Announcement Date.

Deemed gain where amounts to be deducted from ACB exceed cost plus amounts added to ACB

ITA
40(3)

Subsection 40(3) of the Act provides rules that apply where, at a particular time in a particular taxation year, the adjusted cost base ("ACB") of a capital property has been reduced below nil as a result of the adjustments required under subsection 53(2). These rules ensure that the "negative" ACB is generally treated as a capital gain of the taxpayer from a notional disposition of a property.

Paragraph 40(3)(*c*) is the rule that deems there to be a gain from a notional disposition of the property. Paragraph 40(3)(*d*) is the rule that deems there to be a notional disposition of the property.

Whereas paragraph 40(3)(*c*) refers to the notional disposition as having occurred at the particular time mentioned above (i.e., the time at which the ACB goes below nil), paragraph 40(3)(*d*) refers to the notional disposition as having occurred in the particular year, but without explicitly indicating that the notional disposition occurred at the particular time. The rule in paragraph 40(3)(*d*) is for the purposes of section 93, the subsection 95(1) definition of "foreign accrual property income", and section 110.6.

Paragraph 40(3)(*e*) is a rule that establishes an amount of proceeds of disposition for the purposes of section 93.

Paragraph 40(3)(*d*) is replaced by amended paragraph (*d*) and new paragraph (*e*).

Amended paragraph (*d*) is the rule that deems there to be a notional disposition of the property for the purposes of section 93. Amended paragraph (*d*) refers to the notional disposition as having occurred at the particular time, thus ensuring a clearer application of section 93 of the Act, which makes reference to the time of a disposition as opposed to the year of the disposition.

New paragraph (*e*) is the rule that deems there to be a notional disposition of the property for the purposes of section 110.6. Like old paragraph (*d*), new paragraph (*e*) refers to the notional disposition as having occurred in the particular year.

Paragraph (*d*) is also amended to remove the references to the "foreign accrual property income" definition, as paragraph (*c*) is sufficient for the purposes of that definition, without the need for a rule like paragraph (*d*) or (*e*).

Existing paragraph (*e*) is effectively repealed as section 93 no longer requires the establishment of an amount of proceeds of disposition. For more details, refer to the commentary below under section 93.

Paragraphs 40(3)(*c*) and (*d*) are also amended to modernize their language.

These amendments apply after Announcement Date.

Loss on certain properties

ITA
40(3.3) to (3.6)

Subsections 40(3.3) to (3.6) of the Act contain loss denial rules that are similar to the one in subsection 13(21.2), except that they deal with non-depreciable capital property.

The amendments to paragraph 40(3.3)(*a*) and subsection 40(3.6) are similar to the first amendment discussed under subsection 13(21.2) above, and readers are referred to the commentary on the latter subsection for more information.

The amendments to subparagraph 40(3.4)(*b*)(v) are similar to the second amendment discussed under subsection 13(21.2) above, and readers are referred to the commentary on the latter subsection for more information.

Paragraph 40(3.5)(*c*) is also being amended, and there is no analogous provision in the other loss denial rules discussed above. Subsection 40(3.5) mainly provides special rules for the purposes of subsections 40(3.3) and (3.4) to ensure the proper application of these rules when certain corporate reorganizations occur.

Paragraph 40(3.5)(*c*) deals with situations in which the disposed property, i.e. the property in respect of which a loss is suspended under subsection 40(3.4), is a share of a corporation and that share disappears as a result of certain mergers or wind-ups involving that corporation. Where paragraph 40(3.5)(*c*) applies, it deems the otherwise non-existent share to be held by either the new corporation formed on the merger or the parent corporation to the wind-up, as the case may be, while the new corporation or parent is affiliated with the original transferor of the share.

The amendments to paragraph 40(3.5)(c) ensure that dispositions of shares of a foreign affiliate that undergoes certain types of corporate reorganizations will be subject to these continuity rules on a basis similar to dispositions of shares of domestic corporations.

All of these amendments (for subsections 40(3.3) to (3.6)) apply, essentially, after Announcement Date.

Clause 7

Amounts to be deducted

ITA
53(2)(*b*)

Subsection 53(2) of the Act sets out a number of amounts that are deducted in computing a taxpayer's adjusted cost base ("ACB") of a property at a particular time. Paragraph 53(2)(*b*) provides that, where the property is a share of the capital stock of a non-resident corporation, there is to be deducted all amounts described in subparagraph (i) plus all amounts described in subparagraph (ii). The amounts described in subparagraph (i) are any amounts required by paragraph 80.1(4)(*d*) or section 92 to be deducted in computing the taxpayer's ACB of the share. The amounts described in subparagraph (ii) are any amounts received by the taxpayer after 1971 and before the particular time on a reduction of the paid-up capital of the non-resident corporation in respect of the share.

Paragraph 53(2)(*b*) is being amended to provide that reductions, made after Announcement Date, of the paid-up capital of a foreign affiliate in respect of a share of the foreign affiliate no longer reduce the ACB of the share. This amendment is consequential to the new definition of a dividend from a foreign affiliate (which is effected by the combined operation of new subsections 90(2) and (3) of the Act) that should include reductions of capital by a foreign affiliate. For more details, refer to the commentary below dealing with those provisions.

This amendment applies after Announcement Date.

Clause 8

Safe income

ITA
55(5)(*d*)

Section 55 of the Act deals with certain Canadian domestic corporate reorganization transactions. Its main operative rule is found in subsection 55(2). Subsection 55(2) is an anti-avoidance provision directed at arrangements designed to use the inter-corporate dividend exemption in section 112 of the Act to unduly reduce a capital gain on a sale of shares of a Canadian corporation. If it applies, subsection 55(2) recharacterizes dividends in respect of the shares of a Canadian corporation as proceeds from the sale of the shares or as a capital gain.

Subsection 55(2) does not apply where the gain that has been reduced can be attributed to the share's portion of the income ("safe income") earned or realized by any corporation after 1971 and before the "safe-income determination time", a term that is defined in subsection 55(1).

Paragraph 55(5)(*d*) provides a mechanical rule to compute the safe income of a foreign affiliate of the relevant Canadian corporation. This rule is being amended as a consequence of the recent introduction of the concept of a "tax-free surplus balance", in subsection 5905(5.5) of the Regulations, and to ensure that appropriate amounts in respect of foreign affiliates are counted towards the safe income of a relevant Canadian corporation.

This amendment applies in respect of dividends received after Announcement Date by a corporation resident in Canada but there is "grandfathering" for transactions in progress as of Announcement Date.

Clause 9

Exception to share-for-share exchange rollover

ITA
85.1(4)

Subsection 85.1(4) of the Act is an exception to the rule in subsection 85.1(3) which otherwise allows a taxpayer to transfer the shares of a foreign affiliate to another foreign affiliate on a “rollover” basis. Subsection 85.1(4) is an anti-avoidance provision that provides that the rollover in subsection 85.1(3) will not apply where a share of one foreign affiliate, which was transferred to a second foreign affiliate, is subsequently sold as part of the same series of transactions to an arm's length party (other than a foreign affiliate of the taxpayer) if all or substantially all of the first affiliate's property is excluded property (as defined in subsection 95(1)).

Subsection 85.1(4) is being amended in a number of ways, as follows.

A new exception is being added such that the rollover in subsection 85.1(3) will no longer apply where the shares transferred have an inherent loss. The intention is to have these transfers subject to the same rules as other transfers of capital property, as contemplated by subsections 40(3.3) and (3.4) of the Act. In other words, the loss on such dispositions of foreign affiliate shares would be suspended and released only upon the sale of the shares outside of the affiliated group, or upon the other types of release events set out in paragraph 40(3.4)(*b*). A further implication of this new rule is that it would no longer be possible to shift the loss over to shares of a transferee affiliate nor to duplicate these losses by creating an inherent loss for the transferee affiliate.

The introduction of the new exception to subsection 85.1(3) has necessitated the restructuring of subsection 85.1(4) into paragraphs (*a*) and (*b*). The new exception is contained in paragraph (*b*); the existing exception is in paragraph (*a*).

The existing exception, now contained in paragraph (*a*), is also being amended. First, the rule will now capture dispositions that are part of a single transaction or event, as well as those that are part of a series. Second, the rule will now also apply to dispositions to arm’s length partnerships. Third, the carve-out for foreign affiliate purchasers is being narrowed such that only arm’s length foreign affiliates in which the taxpayer has a qualifying interest (as defined in paragraph 95(2)(*m*) of the Act) will be exempted from this anti-avoidance rule.

All of these amendments to subsection 85.1(4) apply to dispositions that occur after Announcement Date.

Clause 10

Amalgamations

ITA
87(2)(*u*)(ii)

Section 87 of the Act provides rules that apply where there has been an amalgamation of two or more taxable Canadian corporations to form a new corporation. The new corporation is generally treated as a continuation of its predecessor corporations for the purposes of the Act.

Paragraph 87(2)(*u*) is a rule that provides for continuity of the predecessor corporations in respect of certain attributes of their foreign affiliates. Subparagraph 87(2)(*u*)(ii) effects such continuity with respect to “exempt dividends”, as defined in subsection 93(3) of the Act, as they apply in the context of the foreign affiliate stop-loss rules in subsections 93(2) to (2.3) of the Act.

Subparagraph 87(2)(*u*)(ii) is being amended as a consequence of the restructuring of the those stop-loss rules. For details about the restructuring of those stop-loss rules, refer to the commentary under subsections 93(2) to (2.32).

This amendment generally applies on the same basis as new subsection 93(2.01) of the Act.

Clause 11

Liquidation and dissolution of foreign affiliate

ITA
88(3)

Subsection 88(3) of the Act provides certain rules that apply on the dissolution of a controlled foreign affiliate of a taxpayer where the affiliate distributes shares of another foreign affiliate of the taxpayer to the taxpayer. Subsection 88(3) deals with the consequences to the dissolving affiliate and the taxpayer of the distribution and acquisition of the shares of the other affiliate and the consequences of the disposition of the shares of the dissolving affiliate by the taxpayer as a result of the dissolution.

Subsection 88(3) is being significantly amended, as follows:

- To broaden its application to all properties received by the taxpayer on a liquidation and dissolution of a foreign affiliate of the taxpayer;

- To allow rollovers of all properties, rather than just shares of another foreign affiliate, in the case of a qualifying liquidation and dissolution (“QLAD”);

- To limit the automatic, i.e. non-QLAD, rollover of shares of another foreign affiliate to shares that are excluded property;

- To deny a loss on the disposition of the shares of the dissolving affiliate in the case of a QLAD; and

- To provide three special elections that allow taxpayers to choose, in certain circumstances, the amount for which distributed property is deemed to be disposed of, and acquired for, as follows:
    - Under a relevant cost base (as defined in subsection 95(4) of the Act) election,
    - Under the suppression election in new subsection 88(3.3), and
    - Under the taxable Canadian property election in new subsection 88(3.5).

It is also notable that the description of variable B in the definition of “foreign accrual property income” (“FAPI”) in subsection 95(1) of the Act is being amended to ensure that any gains created under a relevant cost base election made for the purposes of subsection 88(3) are included in FAPI. For more details on this FAPI amendment, refer to the commentary under subsection 95(1).

Qualifying liquidation and dissolution

ITA
88(3.1)

New subsection 88(3.1) of the Act defines the term “qualifying liquidation and dissolution” or “QLAD”. This term is mainly relevant for amended subsection 88(3), but it is also used in new subsections 88(3.3) and (3.5), as discussed below. A QLAD is meant to identify the circumstances in which a foreign affiliate of a taxpayer is considered to be substantially wholly-owned, such that a rollover of all assets upon the liquidation and dissolution of such an affiliate is considered appropriate.

A QLAD will exist where the taxpayer elects (pursuant to rules prescribed in new section 5911 of the Regulations) to have that concept apply, and one of two tests is met, being either

- the taxpayer owns at least 90% of the shares of the affiliate throughout the liquidation and dissolution, or
- the taxpayer, during the course of the liquidation and distribution, receives at least 90% of the net assets of the affiliate and has at least 90% of the voting power in the affiliate’s shares.

Net distribution amount

ITA
88(3.2)

New subsection 88(3.2) of the Act defines the term “net distribution amount” in respect of a distributed property for the purposes of determining, under new paragraph 88(3)(*d*), the proceeds of disposition to a taxpayer of the shares of a foreign affiliate of the taxpayer that is liquidated and dissolved. The net distribution amount of a distributed property is the cost amount of that property to the taxpayer less any debts assumed by the taxpayer in consideration for that property.

Suppression election

ITA
88(3.3) and (3.4)

New subsections 88(3.3) and (3.4) of the Act allow a taxpayer to elect, in accordance with rules prescribed in section 5911 of the Regulations, to reduce (i.e. “suppress”) the amount for which a distributed property is considered disposed of under paragraph 88(3)(*a*) where the distributed property is capital property of a foreign affiliate that is the subject of a QLAD. This reduced amount is then deemed under paragraph 88(3)(*c*) to be the taxpayer’s cost of the property which in turn, by virtue of the interaction between the description of A in subsection 88(3.2) with paragraph 88(3)(*d*), affects the taxpayer’s proceeds of disposition of the dissolving affiliate’s shares. The purpose of this election is to allow taxpayers to reduce the capital gain that would otherwise arise on a disposition of the dissolving affiliate’s shares. As such, the ability to suppress the disposition proceeds of distributed property is only available to the extent the taxpayer is able to avoid such a gain (as per paragraph 88(3.4)(*b*)).

In order to avoid circularity with the rules for determining surplus in the context of a subsection 88(3) liquidation and dissolution, this suppression rule is “turned off” by virtue of a special “reading rule” in clause 5907(9)(*b*)(i)(A) of the Regulations. This special reading is necessary because of the interaction of the suppression rule with the dividend election under subsection 93(1) of the Act.

For example, if the taxpayer’s gain otherwise determined (i.e. before any subsection 93(1) election or a suppression election) in respect of the disposition of a wholly-owned dissolving affiliate’s shares is $1,000 and the exempt surplus of the affiliate as otherwise determined is $700, the taxpayer would, in the absence of the suppression election but after the subsection 93(1) election, realize a capital gain in respect of the dissolving affiliate’s shares of $300. If the taxpayer then elects under subsection 88(3.3) to reduce the proceeds of disposition of Property A from $1,500 to $1,200, that $300 reduction would otherwise create a loss for surplus purposes and that loss could reduce the amount of exempt surplus available for the subsection 93(1) election to $400. Thus the gain, even after the $300 suppression, would still be $300. The special reading rule in clause 5907(9)(*b*)(i)(A) avoids this circularity by ignoring the suppression consequences and maintaining exempt surplus at $700. This allows the gain, in this example, to be totally eliminated.

This suppression rule is also “turned off” for the purposes of determining the allowable capital losses of a foreign affiliate in respect of non-excluded property, under paragraph (*a*) of the description of E in the “foreign accrual property income” (“FAPI”) definition in subsection 95(1), in order to prevent taxpayers from using this election to create FAPI losses.

Taxable Canadian property

ITA
88(3.5)

New subsection 88(3.5) of the Act allows a taxpayer and a foreign affiliate of the taxpayer to jointly elect, in accordance with rules prescribed in section 5911 of the Regulations, to use adjusted cost base (“ACB”), rather than relevant cost base (“RCB”), as the amount for which distributed property is considered disposed of under paragraph 88(3)(*a*) in the context of a QLAD where the distributed property is non-treaty-protected taxable Canadian property of the affiliate that is shares of a Canadian-resident corporation. Such an election might be desirable where, for example, the RCB of the property is higher than its ACB and section 115 of the Act would otherwise cause the affiliate to incur Canadian income tax on the disposition.

The amendments to subsection 88(3), and new subsections 88(3.1) to (3.5), apply in respect of liquidations and dissolutions that begin after February 27, 2004. However, taxpayers may elect to have different rules apply up to Announcement Date.

Clause 12

Dividends from non-resident corporations and loans from foreign affiliates

ITA
90

Section 90 of the Act includes in the income of a taxpayer resident in Canada any dividends received from a non-resident corporation.

Section 90 is being significantly expanded to provide, among other things, specific rules for dividends from foreign affiliates and to address avoidance techniques involving so-called “upstream loans”. As more fully explained below, new subsections 90(1) to (3) relate to dividends, while new subsections 90(4) to (10) relate to upstream loans.

Dividends received from non-resident corporation

ITA
90(1)

New subsection 90(1) is substantively the same as existing section 90, the only difference being the modernization of its language.

ITA
90(2) and (3)

New subsections 90(2) and (3), taken together, provide an all-encompassing definition of a dividend from a foreign affiliate for the purposes of the Act. By virtue of its application for all purposes of the Act, these rules also apply for all purposes of the Regulations, notably Part LIX of the Regulations which deals with the surplus accounts of a foreign affiliate.

Essentially subsection 90(2) treats all pro-rata distributions in respect of shares of a foreign affiliate as dividends, except where they are received on a liquidation of the affiliate or on a redemption of its shares. The only other way in which a dividend from a foreign affiliate will be considered to arise is if a specific provision of Part I of the Act so deems it, as per new subsection 90(3).

One of the implications of this new dividend definition for foreign affiliates is that the concept of a reduction of paid-up capital of a foreign affiliate should become irrelevant. This is why paragraph 53(2)(*b*) is being amended, as explained above. However, as noted in the commentary for new paragraph 5901(2)(*b*) of the Regulations, taxpayers will be able to elect, in most circumstances, to ignore the normal surplus ordering rules and instead have dividends paid by a foreign affiliate deemed to be paid out of pre-acquisition surplus. Since pre-acquisition surplus dividends are fully deductible from taxable income and reduce the adjusted cost base (“ACB”) of a foreign affiliate’s shares, this new regime will have the effect of allowing taxpayers to access the ACB of the shares of their foreign affiliates as a surrogate for the capital of their affiliates.

New subsections 90(1) to (3) apply after Announcement Date. However, if a taxpayer elects retroactive application of the new pre-acquisition surplus election in subsection 5901(2) of the Regulations, subsections 90(1) to (3) also apply after February 27, 2004 and on or before Announcement Date. In that case, there would, on or before Announcement Date, be a transitional reading of paragraph 90(2)(*a*) whereby amounts received on a reduction of the paid-up capital of the foreign affiliate would not be deemed under subsection 90(2) to be a dividend.

Loan from foreign affiliate (and repayments)

ITA
90(4) to (10)

New subsections 90(4) to (10) of the Act introduce a series of rules to address upstream loans. These rules are anti-avoidance rules designed to prevent taxpayers from making synthetic dividend distributions from foreign affiliates in order to avoid what would otherwise be income inclusions under new subsection 90(1) that are not fully offset by deductions under paragraphs 113(1)(*a*) to (*b*) of the Act.

ITA
90(4)

New subsection 90(4) is the main operative component of the “upstream loan” rule. This rule, which is modelled on subsection 15(2) of the Act, provides for an inclusion of “specified amounts” in the income of a taxpayer resident in Canada where loans are made by foreign affiliates of the taxpayer to certain “specified debtors”. “Specified amount” and “specified debtor” are defined in new subsection 90(10).

Given the potential for overlap between subsections 15(2) and 90(4), subsection 90(4) does not apply where subsection 15(2) already provides for an income inclusion.

Note that the reference in subsection 90(4) to a “member” of a partnership is to be applied with due regard to the “look-through” rule in new subsection 93.1(3).

ITA
90(5)

New subsection 90(5) of the Act provides some important exceptions to subsection 90(4). Specifically, subsection 90(4) will generally not apply to loans or indebtedness that are repaid within two years, nor to loans or indebtedness that arise in the ordinary course of the business of the creditor. These two exceptions are similar to those that apply in the context of subsection 15(2). They are found in new paragraphs 90(5)(*a*) and (*b*), respectively.

ITA
90(6)

A further exception is provided under new subsection 90(6). However, this exception works by way of an inclusion and deduction on an annual basis for the period during which the loan or indebtedness is outstanding. The deduction under subsection 90(6) applies to a portion of a specified amount in respect of a loan or indebtedness that is included in income under subsection 90(4) (or subsection 90(7), as discussed below) where three conditions are met.

The first condition is that the taxpayer must demonstrate that if the specified amount in respect of the portion of the loan or indebtedness had instead been received by the taxpayer as a dividend, the taxpayer would have been entitled to a full deduction for that dividend under any of paragraphs 113(1)(*a*) to (*b*). The use of the word “full” is meant to address situations where a hybrid surplus dividend would be received but the hybrid underlying taxes would be insufficient to enable the taxpayer to fully offset the inclusion under subsection 90(1). Where this is the case, such hypothetical dividends would not be considered in determining eligibility for the subsection 90(6) deduction. In the case of taxable surplus, because of the ability to make a so-called “disproportionate UFT” election, under paragraph (*b*) of the definition “underlying foreign tax applicable”, it is intended that a taxable surplus amount equal to the grossed-up balance of underlying foreign tax be considered fully deductible.

The second condition is that no dividends can be paid by any relevant foreign affiliate during the time the loan or indebtedness is outstanding. Relevant foreign affiliates are intended to be those that are in the chain of foreign affiliates whose surplus could be aggregated and included in the determination of the hypothetical section 113 deductions referred to in the first condition (i.e. paragraph 90(6)(*a*)).

The third condition is that no other loan or indebtedness made or incurred during the same time period can rely on the same surplus balances in claiming a deduction under subsection 90(6). The second and third conditions are intended to prevent taxpayers from receiving the benefit of the deduction under subsection 90(6) more than once in respect of the same surplus balances. Essentially this deduction is intended to allow taxpayers to make loans instead of paying dividends where there is no intention to achieve a Canadian tax benefit.

It should also be noted that any attempts at getting around subsection 90(4) or fitting into one of the exceptions in subsection 90(5) or (6) that are not within the scope of the intended application of these rules, as set out in these notes, will be subject to review under the general anti-avoidance rule in section 245 of the Act. In particular, it is intended that back-to-back loans, and similar financial arrangements, with arm’s length parties would be considered a misuse of these new provisions and an abuse of the Act as a whole for the purposes of section 245.

ITA
90(7)

New subsection 90(7) provides for the inclusion in the current taxation year of an amount deducted under subsection 90(6) in the immediately preceding taxation year. This inclusion can then be offset by a new deduction under subsection 90(6) if the conditions of that subsection continue to be met.

ITA
90(8)

New subsection 90(8) is a rule to prevent a double deduction in respect of the same loan or indebtedness, or portion thereof. This subsection “turns off” the subsection 90(6) deduction in the year in which the relevant portion of a loan or indebtedness is repaid as that repayment should give rise to a deduction under subsection 90(9).

ITA
90(9)

New subsection 90(9) is analogous to paragraph 20(1)(*j*) and provides for a deduction from a taxpayer's income to the extent that a loan that was subject to subsection 90(4) is repaid in a subsequent taxation year.

In this regard, see also the commentary for new subsection 20(13).

ITA
90(10)

New subsection 90(10) defines the expressions "specified amount" and "specified debtor", which are used in subsection 90(4) and, in the case of "specified amount", in subsections 90(6), (8) and (9).

"Specified amount" is essentially the amount of the loan multiplied by the taxpayer's equity interest in the lending affiliate. This equity interest is measured by reference to the taxpayer's "surplus entitlement percentage" in the affiliate, as defined in subsection 95(1) by reference to subsection 5905(13) of the Regulations. See the commentary under subsection 5905(13), and related provisions, of the Regulations for details about important amendments to the "surplus entitlement percentage" definition.

"Specified debtor" includes the taxpayer, certain non-arm's length persons and certain partnerships of which the taxpayer or non-arm's length persons are members. An exception is made for controlled foreign affiliates ("CFA") of the taxpayer. However, for these purposes, it is the CFA definition in subsection 17(15) that applies. The reference to section 17, as opposed to subsection 17(15), is meant to ensure that the anti-avoidance rule in subsection 17(14) applies for these purposes.

It is also notable that the partnership "look-through" rule in subsection 93.1(1) of the Act is being expanded so that it applies for the purposes of section 90 and, thus, the definition of "specified debtor" in subsection 90(10).

New subsections 90(4) to (8) and (10) apply after Announcement Date and, because it is framed in the context of a taxation year of a taxpayer, new subsection 90(9) applies to taxation years that end after Announcement Date. However, any loans or indebtedness incurred before Announcement Date are subject to a "re-birth" rule that deems the amounts outstanding on Announcement Date to be separate loans or indebtedness issued on that date. This "re-birth" rule is intended to ensure that all pre-Announcement Date loans or indebtedness are entitled to the same two-year repayment window to which new, post-Announcement Date, loans and indebtedness are entitled.

Example

Assumptions

1. *Canco and Cansub are corporations resident in Canada.*

2. *Canco owns all of the shares of Cansub and 40% of the shares of FA1.*

3. *FA1 owns 60% of the shares of FA2.*

4. *Cansub owns the remaining 60% of the shares of FA1 and 40% of the shares of FA2.*

5. *FA1 and FA2 are non-resident corporations and each has only one class of shares.*

6. *On January 15, 2012, FA2 loans $800 to Canco. The loan is repaid by Canco on November 30, 2014.*

7. *Immediately before the loan was made,*

    a. *FA1 had hybrid surplus of $270, and hybrid underlying tax of $30, in respect of both Canco and Cansub, and no other surplus balances; and*

    b. *FA2 had exempt surplus of $200 in respect of both Canco and Cansub, and no other surplus balances.*

8. *Neither FA1 nor FA2 is in the money lending business.*

9. *Canco and Cansub both have a 25% tax rate and both have a December 31st taxation year end.*

Analysis

In this example, the $800 loan made by FA2 to Canco is a "tainted" loan for the purposes of subsection 90(4) as the loan is not repaid within 2 years, and Canco is a "specified debtor" (as defined in subsection 90(10)) in respect of both itself and Cansub.

Subsection 90(4) requires each of Canco and Cansub to include in their income for their 2012 taxation years their respective "specified amount" (as defined in subsection 90(10)) in respect of the $800 loan made by FA2 to Canco. The inclusion for Canco is $192 ($800 multiplied by Canco's surplus entitlement percentage ("SEP") in FA2 of 24%), and for Cansub it is $608 ($800 multiplied by Cansub's SEP in FA2 of 76%).

However, Canco and Cansub are entitled to partially offsetting deductions under subsection 90(6) in 2012 and 2013. These deductions are based on what the results would have been if FA2 had instead paid the $800 as dividends up the chain to its two *ultimate shareholders, Canco and Cansub. In this case, an $800 dividend from FA2 would have moved cash of $320 to Cansub, of which $80 would have been deductible under paragraph 113(1)(a), and would have moved $480 of cash and $120 of exempt surplus to FA1. FA1 would then have paid a $480 dividend with Canco and Cansub receiving $192 and $288 of cash, respectively. Of the $192 dividend received by Canco, $48 would have been deductible under paragraph 113(1)(a). Of the $288 dividend received by Cansub, $72 would have been deductible under paragraph 113(1)(a). Because all dividends from exempt surplus are <u>fully</u> deductible, all such hypothetical dividends are eligible for deduction under subsection 90(6).*

Canco and Cansub would also be considered to have received hybrid surplus dividends from FA1 in the amount of $108 and $162, respectively. However, because only a portion of these dividends would be deductible under paragraph 113(1)(a.1), because the 10% hybrid underlying tax rate is below the Canadian capital gains tax rate of 12.5%, these dividends would not be considered fully deductible and are thus not eligible for the subsection 90(6) deduction.

Thus, in this example, the following inclusions and deductions would arise in 2012, assuming the conditions of paragraphs 90(6)(b) and (c) are met during the period from January 15th to the end of 2012:

<u>*Canco*</u>

- *$192 inclusion under subsection 90(4); and*
- *$48 deduction under subsection 90(6).*

<u>*Cansub*</u>

- *$608 inclusion under subsection 90(4); and*
- *$152 ($80 + $72) deduction under subsection 90(6).*

Under subsection 90(7), Canco and Cansub would have to include their subsection 90(6) amounts in income in 2013, but they would be entitled to deduct equivalent amounts under subsection 90(6) in that year provided the conditions of paragraphs 90(6)(b) and (c) continue to be met during that entire year.

In the 2014 taxation year, subsection 90(7) would again require an inclusion of the subsection 90(6) amounts. However, no deduction would be claimable under subsection 90(6) in that year, by virtue of subsection 90(8), because the loan is repaid in that year and subsection 90(9) should give each of Canco and Cansub a fully offsetting deduction.

Clause 13

Adjustment re adjusted cost base

ITA
92(1.2)

New subsection 92(1.2) of the Act is added to clarify that the addition to the adjusted cost base of a share of a foreign affiliate that is contemplated in paragraph 93(4)(*b*) of the Act is to apply for all purposes of the Act.

This amendment applies after February 27, 2004.

Clause 14

Election re disposition of share of foreign affiliate

ITA
93(1)

Where a share of the capital stock of a particular foreign affiliate of a corporation resident in Canada is disposed of by the corporation (referred to in this commentary as the “disposing corporation”) or by another foreign affiliate (referred to in this commentary as the “disposing affiliate”) of the corporation, subsection 93(1) of the Act permits the disposing corporation or the disposing affiliate, as the case may be, to elect to treat all or a portion of the proceeds of disposition of the share as a dividend.

Subsection 93(1) currently provides that the amount elected cannot exceed the proceeds of disposition of the share, as otherwise determined. The amount elected is deemed to be a dividend received on the share by the disposing corporation, or the disposing affiliate, and is deemed not to be proceeds of disposition.

Subsection 93(1) is being amended to limit the elected amount to the amount of the gain that would otherwise be realized on the disposition of the share.

This amendment applies in respect of elections made in respect of dispositions that occur after Announcement Date. However, the current version of subsection 93(1) will continue to apply where it is being applied for the purposes of the current version of paragraph 55(5)(*d*) of the Act which, in some circumstances, can apply to dispositions after Announcement Date.

Deemed election

ITA
93(1.1) and (1.11)

Current subsection 93(1.1) provides, in certain circumstances, that the rules in subsection 93(1) will automatically apply, based on a prescribed elected amount, in respect of a disposition of a share of a foreign affiliate of a corporation resident in Canada as if the corporation had made an actual election under subsection 93(1).

Current subsection 93(1.1) of the Act applies where:

- the transferor, being a foreign affiliate of a corporation, disposes of a share of the capital stock of another foreign affiliate of the corporation,
- the disposed share was “excluded property” (as defined in subsection 95(1)) of the transferor, and
- none of paragraphs 95(2)(*c*), (*d*) and (*e*) applies to the disposition.

The deemed elected amount is prescribed under subsection 5902(6) of the Regulations to be the lesser of the capital gain from the disposition of the share and the share’s portion of the aggregate net surplus of the disposed affiliate and all foreign affiliates underneath.

Subsection 93(1.1) is being restructured into two subsections. The operative rule is being moved to new subsection 93(1.11) while the conditions for its application are found in amended subsection 93(1.1). In addition, the deeming provision will now also apply where a taxpayer makes a pre-acquisition surplus election under subparagraph 5901(2)(*b*)(i) of the Regulations and that election causes a capital gain by virtue of the operation of subsection 40(3) of the Act. Readers are referred to the commentary on paragraph 5901(2)(*b*) for more details.

Subsection 93(1.1) is also being expanded, as a result of these amendments, so that it applies to all shares of foreign affiliates that are disposed of by another foreign affiliate – in other words, it is no longer limited to certain types of excluded property.

Amended subsection 93(1.1) and new subsection 93(1.11) apply to dispositions of foreign affiliate shares that occur after Announcement Date. However, if a taxpayer elects to have the new pre-acquisition surplus rule (in paragraph 5901(2)(*b*) of the Regulations) apply retroactively, these amendments will also apply retroactively, i.e. for dispositions that occur after February 27, 2004.

Foreign affiliate “stop-loss” rules

ITA
93(2) to (2.32)

Current subsection 93(2) of the Act provides rules that limit (or “stop”) the loss of a corporation resident in Canada from the disposition of a share of a foreign affiliate where exempt dividends (as defined in subsection 93(3)) are paid in respect of that share. It similarly deals with losses of a foreign affiliate from a disposition of a share of another foreign affiliate, where that share is not excluded property.

Current subsections 93(2.1) to (2.3) provide rules similar to those in subsection 93(2) to deal with dispositions by partnerships of foreign affiliate shares and dispositions of certain partnership interests where the disposed partnership holds foreign affiliate shares. The discussion below in the context of subsection 93(2) should apply equally to subsections 93(2.1) to (2.3) and thus only limited further comments are made herein in respect of those subsections.

Loss limitation on disposition of share of foreign affiliate

ITA
93(2) to (2.02)

Subsection 93(2) is being split into two subsections: new subsection 93(2) defines the losses to which the loss limitation rule applies and new subsection 93(2.01) sets out the loss limitation rule. A new subsection 93(2.02) is also being added which defines the term “specified gain” for the purposes of subparagraph 93(2.01)(*b*)(ii). (Each of subsections 93(2.1), (2.2) and (2.3) is similarly being split into two subsections and given a separate subsection which defines “specified gain”.)

The main substantive amendment to this series of rules is the addition of a new aspect of these rules that is aimed at preserving, in certain circumstances, the portion of a loss that relates to foreign currency fluctuations, without regard to the quantum of exempt dividends paid in respect of the shares. That portion is preserved to the extent of a corresponding foreign currency gain from certain transactions (“hedging transactions”) that arise in connection with the acquisition of the shares. However, as a result of the “specified gain” concept, a corresponding gain will not be taken into account where the taxpayer or a non-arm’s length person has also hedged the hedging transaction. In other words, if the gain from the hedging transaction is already covered off by a loss (whether actual or unrealized) from a related hedging transaction, a loss from the foreign affiliate share disposition will not be entitled to further foreign currency protection under new subsection 93(2.01).

As a result of the restructuring of subsections 93(2) to (2.3), a number of consequential reference changes are also being made within new subsections 93(2) to (2.32) as well as in subparagraph 87(2)(*u*)(ii), as discussed above, and subsections 93(3) and (4), as discussed below.

New subsections 93(2) to (2.32) generally apply to dispositions of shares and partnership interests that occur after February 27, 2004. However, taxpayers can elect to have these rules apply as of 1995, and there are a number of transitional rules. The complexity of the transitional rules is primarily due to three things. First, current subsections 93(2.1) to (2.3) only came into force in 1999 and thus certain coordinating readings are necessary for taxpayers that make the retroactive election. Second, for taxpayers that make the retroactive election, different capital gains inclusion rates apply for certain periods. Third, taxpayers are being given options to apply certain aspects of a previous draft version of these amendments up to the day that is one year after Announcement Date.

Exempt dividends

ITA
93(3)

Subsection 93(3) of the Act is an interpretive rule for the foreign affiliate "stop-loss" rules in subsections 93(2) to (2.3) of the Act. It provides the circumstances in which certain dividends received from a foreign affiliate are considered "exempt dividends" for the purposes of those stop-loss rules.

Subsection 93(3) is being amended consequential to the restructuring of subsections 93(2) to (2.3), as discussed above, and to the introduction of the concept of "hybrid surplus", for which a deduction may be claimed under paragraph 113(1)(*a.1*).

These amendments apply when new subsection 93(2.01) applies. However, a transitional reading of the preamble of subsection 93(3) applies when new subsection 93(2.01) applies but new subsection 93(2.11) does not apply. As well, there is a transitional reading of paragraph 93(3)(*a*) that maintains the current rule for dispositions that occur on or before Announcement Date, as "hybrid surplus" only applies to dispositions after that time.

Loss on disposition of shares of foreign affiliate

ITA
93(4)

Subsection 93(4) of the Act applies where a taxpayer resident in Canada or a foreign affiliate of such a taxpayer (the "vendor") has acquired shares of one foreign affiliate on the disposition of shares of another foreign affiliate. Any capital loss realized by the vendor on the disposition is denied and the amount of such a loss (minus the amount of any portion of such a loss that is attributable to exempt dividends, as defined in subsection 93(3), received on that share and that thereby reduced a capital loss by virtue of subsection 93(2)) is added to the vendor's adjusted cost base of the shares of the acquired affiliate.

Subsection 93(4) is being amended to modernize its language, clarify its application, and to incorporate references to the new version of subsection 93(2), as discussed above.

Subsection 93(4) is also being amended so that it does not apply to excluded property dispositions of a foreign affiliate. Readers are referred to the commentary under subsection 13(21.2) for more information.

Except for the carve-out of excluded property of a foreign affiliate, the amendments to subsection 93(4) apply to any acquisition of shares of the capital stock of a foreign affiliate of a taxpayer that occurs after February 27, 2004. However, if the taxpayer has made the retroactive election described in the commentary to subsection 93(2), the amendments to subsection 93(4) apply to acquisitions of shares that occur after 1994. The excluded property carve-out applies for acquisitions that occur after Announcement Date.

Clause 15

Shares held by a partnership

ITA
93.1(1)

Subsection 93.1(1) of the Act applies for the purpose of determining whether a non-resident corporation is a foreign affiliate of a corporation resident in Canada, for certain enumerated provisions of the Act and Regulations, where the Canadian corporation owns a non-resident corporation's shares through a partnership. In this regard, subsection 93.1(1) deems the Canadian corporation to own its proportionate number of the non-resident corporation's shares based on its relative fair market value interest in the partnership.

Subsection 93.1(1) is being amended to add section 90 of the Act to its list of enumerated provisions. This amendment is consequential to the introduction of the "upstream loan" rule in section 90, as discussed above.

This amendment applies after Announcement Date.

Tiered partnerships

ITA
93.1(3)

New subsection 93.1(3) of the Act is being added to replace and expand upon an existing provision of the Act that deals with tiered partnerships. Currently, paragraph 95(2)(*u*) of the Act provides "look-through" rules to deal with cases where one partnership (i.e. an upper-tier partnership) is a member of another partnership (i.e. a lower-tier partnership), but these rules only apply for specifically identified provisions of the Act.

New subsection 93.1(3) applies the look-through rules of paragraph 95(2)(*u*) more generally in respect of all of subdivision i of Division B of Part I of the Act (i.e. sections

90 to 95) as well as to certain other provisions of the Act that are outside of subdivision i. However, the broad application to subdivision i is subject to an exception for situations where such a look-through would not be appropriate in the context of a particular provision. For example, look-through treatment under subsection 93.1(3) would not be appropriate in subsection 93.1(1) because that subsection works iteratively to achieve a look-through of its own.

New subsection 93.1(3) applies to foreign affiliate taxation years that end after Announcement Date.

Clause 16

ITA
95

Section 95 of the Act defines a number of terms and provides rules relating to the taxation of shareholders of foreign affiliates.

Definitions

ITA
95(1)

Subsection 95(1) defines a number of terms that apply for the purposes of subdivision i of Division B of Part I of the Act.

“foreign accrual property income”

The definition “foreign accrual property income” (“FAPI”) in subsection 95(1) is relevant for the purposes of section 91 and for the purposes of determining the tax surpluses and deficits of a foreign affiliate of a taxpayer. Section 91 provides rules for determining amounts that the taxpayer is to include in computing its income for a particular taxation year as income from a share of a controlled foreign affiliate.

Variables A to C of the FAPI definition contain the additions to FAPI and variables D to H contain the deductions from FAPI.

The formula in the FAPI definition is being amended to add new variable F.1 to incorporate the concept of a “foreign accrual capital loss”. As well, existing variables B, E and G are being amended. See below for more details.

Under current variable B, the amount added to FAPI is the portion of the affiliate’s taxable capital gains for the year from dispositions of property, other than dispositions of excluded property to which none of paragraphs 95(2)(*c*), (*d*) and (*e*) apply, that may reasonably be considered to have accrued after its 1975 taxation year.

Variable B is being expanded to include certain gains on income account and any gains realized under paragraph 88(3)(*a*) or 95(2)(*d.1*).

Current variable E allows a deduction from FAPI for the allowable portion of current year capital losses of a foreign affiliate. Variable E is being amended to limit that deduction where the taxable portion of current year capital gains of the affiliate (that are included in variable B) is less than such allowable capital losses. This amendment is part of an initiative to bring the foreign affiliate FAPI rules in line with the rules applicable to Canadian corporations, i.e. the rules that "stream" capital losses against capital gains. Variable E is also being amended to disable the suppression rule in subsection 88(3.3). For more details, refer to the above commentary for that subsection.

As noted above, a new variable F.1 is being added to the FAPI definition. Variable F.1 allows taxpayers to deduct "foreign accrual capital losses" ("FACLs"), a new concept that is set out in new section 5903.1 of the Regulations. This new concept is part of the capital loss streaming initiative noted above. Taxpayers will now have to separately apply FACLs, under variable F.1, and "foreign accrual property losses" ("FAPLs"), under variable F, in computing FAPI. As with the new limitation on variable E deductions, discussed above, FACL claims will be limited by the capital gains of the affiliate that are included in variable B (after reduction for any claims for current year losses under variable E).

The intended effect of the separate deduction of FAPLs and FACLs is that taxpayers should no longer be able to reduce FAPI earnings that are on income account with FAPI losses that are on capital account. For more details on FACLs, readers are referred to the commentary below on new section 5903.1 of the Regulations.

Variable G of the FAPI definition is part of the forgiveness of debt rules in the FAPI regime. Variable G works hand-in-hand with variables A.1 and A.2 of the FAPI definition so that debt forgiveness inclusions only grind FAPI losses when those losses are claimed. Variable G is being amended as a consequence of the addition of variable F.1.

The amendments to the FAPI formula and variable G, and the addition of variable F.1, apply to foreign affiliate taxation years that end after Announcement Date.

The amendment to variable B applies in respect of taxation years of a foreign affiliate that end after December 19, 2002.

The amendments to variable E apply to dispositions that occur after February 27, 2004, but a transitional reading applies for dispositions occurring in foreign affiliate taxation years that end on or before Announcement Date.

"participating percentage"

The "participating percentage" of a share owned by a taxpayer in respect of a controlled foreign affiliate of the taxpayer is relevant in determining the amount to be included in the taxpayer's income in respect of the controlled foreign affiliate's FAPI.

Subparagraph (*b*)(i) of the definition "participating percentage" applies in the case where each corporation that is relevant to the determination of a taxpayer's "equity percentage" in a particular foreign affiliate has only one class of issued shares. In that case, the participating percentage is determined by reference to a simple "equity percentage".

Subparagraph (*b*)(ii) provides a catch-all rule for situations where subparagraph (*b*)(i) does not apply. Subparagraph (*b*)(ii) requires a more complex determination of participating percentage using prescribed rules that are set out in section 5904 of the Regulations.

Subparagraph (*b*)(i) is being amended to ensure that those prescribed rules, rather than the simple "equity percentage" rule, apply where certain circular shareholdings exist in the relevant chain of foreign affiliates. Section 5904 is also being amended to deal with circular shareholdings, as discussed below.

This amendment applies in respect of taxation years of a foreign affiliate that begin after Announcement Date.

"designated liquidation and dissolution"

The expression "designated liquidation and dissolution" or "DLAD" is relevant for the amended version of paragraph 95(2)(*e*), as discussed below, and applies in respect of the liquidation and dissolution of a foreign affiliate into another foreign affiliate. It has some similarities to the new concept of a "qualifying liquidation and dissolution" ("QLAD"), in new subsection 88(3.1), but it also has some important differences. As with a QLAD, a DLAD is meant to identify the circumstances in which a foreign affiliate of a taxpayer is considered to be substantially wholly-owned, such that a rollover of all assets upon the liquidation and dissolution of such an affiliate is considered appropriate.

Unlike a QLAD, a DLAD is not elective – it applies automatically whenever one of three conditions is met, as follows:

1. the taxpayer has a surplus entitlement percentage in the liquidating affiliate of at least 90% at the time of the first distribution of property;

2. a single foreign affiliate of the taxpayer

    a. receives at least 90% of the net assets of the liquidating affiliate in the course of the liquidation and dissolution, and

  b. has at least 90% of the voting power in the liquidating affiliate's shares at the time of each distribution; or

3. a single foreign affiliate of the taxpayer owns at least 90% of the shares of each class of the liquidating affiliate throughout the liquidation and dissolution.

One of the key implications of conditions 2 and 3 above is that it is not necessary for the taxpayer itself to have a substantially-wholly-owned indirect interest in the liquidating affiliate – that testing is done at the level of the shareholder affiliate.

This new definition applies, along with new paragraph 95(2)(*e*), to liquidations and dissolutions that begin after Announcement Date, but the taxpayer may elect to have it apply to liquidations and dissolutions that begin after December 20, 2002. If such an election is made, that definition is to be read without reference to the 90% voting power test, as discussed above, for liquidations and dissolutions that begin before Announcement Date.

"taxable Canadian business"

Subsection 95(1) of the Act is being amended to add the new definition "taxable Canadian business". This expression is used in new paragraph 95(2)(*j.1*) and amended paragraph 95(2)(*k*). For further details, see the commentaries to those paragraphs.

A "taxable Canadian business" is a Canadian business of a foreign affiliate, or a partnership of which a foreign affiliate is a member, that is fully subject to tax in Canada, i.e. one whose earnings are not exempted under a Canadian tax treaty.

This new definition applies to foreign affiliate taxation years that begin after December 20, 2002. However, a taxpayer may elect to have it (as well as other related provisions) apply to foreign affiliate taxation years that begin after 1994. Where such an election is made, a special reading of the "taxable Canadian business" definition applies for years preceding the introduction, in 1998, of the definition "tax treaty" in subsection 248(1) of the Act.

Foreign affiliate share-for-share exchanges

ITA
95(2)(*c*)

Paragraph 95(2)(*c*) of the Act provides a tax-deferred rollover for certain transfers of shares of a target foreign affiliate by a seller foreign affiliate to a purchaser foreign affiliate where part of the consideration received is shares of the purchaser affiliate. The rule in this paragraph gives similar results to the rule in subsection 85.1(3) of the Act, which is discussed above under the commentary for subsection 85.1(4).

Paragraph 95(2)(*c*) is being amended in a similar way to subsection 85.1(4) in that the rollover in paragraph 95(2)(*c*) will no longer apply where the shares transferred have an inherent loss. The intention is to have these transfers subject to the same rules as other transfers of capital property: in some cases these losses would be realized, in others, such as where subsection 40(3.4) applies, the losses would be suspended. A further implication of this amended rule is that it would no longer be possible to shift the loss over to shares of a transferee affiliate nor to duplicate these losses by creating an inherent loss for the purchaser affiliate.

Paragraph 95(2)(*c*) is also being amended to modernize and clarify its language as well as to incorporate contextual amendments that are consequential to the amendments to the "relevant cost base" definition in subsection 95(4) of the Act, as discussed below.

These amendments apply to dispositions that occur after Announcement Date.

Foreign mergers

ITA
95(2)(*d*)

Paragraph 95(2)(*d*) of the Act provides for the rollover of shares of a predecessor foreign affiliate held by another foreign affiliate of the taxpayer on certain foreign mergers involving predecessor affiliates. This rollover is subject to the taxpayer's ability to elect a higher amount under a so-called "relevant cost base" election.

Subparagraph 95(2)(*d*)(iv) of the Act is being amended to incorporate contextual amendments that are consequential to the amendments to the "relevant cost base" definition in subsection 95(4) of the Act, as discussed below.

The amendments to paragraph 95(2)(*d*) apply to mergers or combinations in respect of a foreign affiliate of a taxpayer that occur after Announcement Date.

ITA
95(2)(*d.1*)

Paragraph 95(2)(*d.1*) of the Act provides for the rollover of capital property on a foreign merger of two or more predecessor foreign corporations, where certain conditions are met. The first such condition (referred to as the "SEP condition") is that the taxpayer's surplus entitlement percentage in each of the predecessor corporations was not less than 90% immediately before the merger and that the taxpayer's surplus entitlement percentage in respect of the new foreign corporation immediately after the merger was not less than 90%. The second such condition (referred to as the "non-recognition condition") is that no gain or loss was recognized, under the income tax law of the country in which the predecessor foreign corporations were resident, in respect of any capital property of a predecessor foreign corporation that became capital property of the new foreign corporation in the course of the foreign merger.

Paragraph 95(2)(*d.1*) is being amended to drop the SEP and non-recognition conditions. Instead, it will now be sufficient for one or more of the predecessor foreign corporations to be, immediately before the merger, a foreign affiliate of the taxpayer and for the new foreign corporation to be, immediately after the merger, a foreign affiliate of the taxpayer in order for this rollover provision to apply.

Also, the rollover will now apply to all property, not just capital property, and it will be based on the "relevant cost base" concept (in subsection 95(4)), as opposed to "cost amount".

It is also important to note the introduction of a so-called "absorptive merger" rule in new subsection 95(4.2) that clarifies how the definition of "foreign merger" is intended to apply, in certain circumstances, for the purposes of paragraph 95(2)(*d.1*).

Paragraph 95(2)(*d.1*) is also being amended to expand its continuity rules to give proper application to the various loss "suspension" rules in sections 13, 14, 18 and 40, as discussed above.

Finally, a new provision (subparagraph (iii)) is being added to ensure that the debt forgiveness rules are properly applied after the merger.

These amendments generally apply to mergers or combinations that occur after Announcement Date. However, taxpayers may elect to have the amendments (other than the ones in respect of stop-loss continuity and debt forgiveness) apply to mergers or combinations that occur after December 20, 2002.

Liquidation and dissolution of a foreign affiliate into another foreign affiliate

ITA
95(2)(*e*) and (*e.1*)

Paragraphs 95(2)(*e*) and (*e.1*) of the Act provide rules that apply where a foreign affiliate of a taxpayer is liquidated and dissolved and property is distributed to shareholders that include other foreign affiliates of the taxpayer. Paragraph 95(2)(*e.1*) deals with liquidating affiliates that are substantially wholly-owned by the taxpayer and paragraph 95(2)(*e*) deals with those that are not.

Current paragraph 95(2)(*e*) provides a rollover, based on the "relevant cost base" concept, only in respect of distributed property that is shares of another foreign affiliate. Current paragraph 95(2)(*e.1*) provides a more broad rollover, but only in respect of capital property of the liquidating affiliate, and this rollover is based on "cost amount".

Similar to current paragraph 95(2)(*d.1*) of the Act, current paragraph 95(2)(*e.1*) contains both a SEP condition and a non-recognition condition.

Paragraphs 95(2)(*e*) and (*e.1*) are being combined, with paragraph 95(2)(*e*) being the "survivor". In respect of liquidations of non-substantially-wholly-owned foreign affiliates, amended paragraph 95(2)(*e*) will now require any foreign affiliate shares disposed of by the liquidating affiliate to be excluded property in order to be eligible for a rollover. In respect of liquidations of substantially-wholly-owned foreign affiliates, the SEP and non-recognition conditions are being dropped and the new conditions for rollover treatment are contained in the new "designated liquidation and dissolution" ("DLAD") definition, which is discussed above. Where there is a DLAD, all property will now be eligible for a rollover, not just capital property, and the rollover will be based on "relevant cost base" rather than "cost amount".

The rules that apply in respect of the disposition of the liquidating affiliate's shares (referred to below as the "disposed shares") are also being significantly amended. New subparagraph 95(2)(*e*)(iv) sets out different computational rules that depend on whether there is an inherent gain in the shares, whether the shares are excluded property and whether the liquidation and dissolution is a DLAD.

New paragraph 95(2)(*e*) imports essentially the same rules that are in the currently-enacted versions of paragraphs 95(2)(*e*) and (*e.1*), but there are new rules for cases where the disposed shares have an inherent loss and the liquidation and dissolution is a DLAD. These new rules are intended to ensure that any inherent losses in respect of the disposed shares are realized by the shareholder affiliate for foreign affiliate surplus purposes. Where such loss shares are excluded property, this is achieved by virtue of the interaction between sub-subclause 95(2)(*e*)(iv)(A)(II)2 and subsection 5907(5) of the Regulations. Where such loss shares are not excluded property, this is achieved by subparagraph (iii) of the description of B in the "hybrid surplus" definition in subsection 5907(1) of the Regulations by reference to a special reading of subclause 95(2)(*e*)(iv)(A)(II) (which effectively ignores the rollover in sub-subclause 1) and the dis-application of subsection 93(4) of the Act (which would otherwise suspend the loss).

Note also the split-up of subsection 5907(5) into two subsections ((5) and (5.01)). This is done to facilitate the application of the currency conversion rule (now found in subsection 5907(5.01)) to subparagraph (iii) of the description of B in the "hybrid surplus" definition. For more details, refer to the commentary on subsections 5907(5) and (5.01) of the Regulations.

Paragraph 95(2)(*e*) is also being amended, in the case of a designated liquidation and dissolution, in order to ensure that

- it has continuity rules that give proper application to the various loss "suspension" rules in sections 13, 14, 18 and 40 of the Act, which are discussed above; and

- the debt forgiveness rules are properly applied after the liquidation.

Amended paragraph 95(2)(*e*) and the repeal of paragraph 95(2)(*e.1*) generally apply in respect of liquidations and dissolutions that begin after Announcement Date, but the taxpayer may elect to have these rules apply to liquidations and dissolutions that begin after December 20, 2002. Where that election is made, transitional rules apply to preserve the prospective application of the surplus reduction rules and the continuity rules relating to stop-loss and debt forgiveness.

Example

Assumptions

1. *Canco, a corporation resident in Canada, owns, and has always owned, 100% of the shares of FA1, a non-resident corporation.*

2. *FA1 owns, and has always owned, 100% of the shares of FA2, also a non-resident corporation. FA1's adjusted cost base ("ACB") of the FA2 shares is C$1,000, the shares are not excluded property and they are held by FA1 as capital property.*

3. *FA2 owns, and has always owned, 100% of the shares of FA3, also a non-resident corporation. FA2's only asset is its shares of FA3 and FA2 has no liabilities. The shares of FA3 have an ACB to FA2 of C$600, a fair market value ("FMV") of C$500, and are held by FA2 as capital property.*

4. *FA2 is liquidated and dissolved.*

Analysis

The liquidation and dissolution of FA2 qualifies as a "designated liquidation and dissolution" ("DLAD"), as defined under subsection 95(1).

Under amended subparagraph 95(2)(e)(i), the shares of FA3 are deemed to be disposed of for proceeds of disposition equal to the relevant cost base ("RCB") of the shares. In this example, because ACB exceeds FMV, there is no ability to elect under paragraph (b) of the definition of RCB in subsection 95(1). Furthermore, as the shares have always been indirectly held by Canco, the carve-out rule in paragraph 95(2)(f.1) should not be applicable. As such, the RCB of the FA3 shares to FA2 is equal to their ACB of C$600.

Under new subparagraph 95(2)(e)(iii), FA1 is deemed to have acquired the FA3 shares at a cost of C$600.

With respect to FA1's disposition of the FA2 shares on the dissolution of FA2, the provisions of subparagraph 95(2)(e)(iv) will apply. If clause 95(2)(e)(iv)(B) were *applicable, the aggregate amount that would be determined under that clause is C$600. Because this amount is less than FA1's C$1,000 ACB of the FA2 shares, FA1's proceeds of disposition of the FA2 shares is determined under the provisions of subclause 95(2)(e)(iv)(A)(II). Since the FA2 shares are not excluded property, sub-subclause 95(2)(e)(iv)(A)(II)1 applies, and under this sub-subclause FA1's proceeds of disposition in respect of the FA2 shares is deemed to be FA1's ACB of those shares, i.e. C$1,000. Thus, under paragraph 95(2)(e), FA1 would have no gain or loss on the disposition of the FA2 shares with the result that no foreign accrual capital loss ("FACL") would be recognized by FA1.*

However, for the purposes of computing FA1's hybrid surplus/deficit balance in respect of Canco, reference must be made to subparagraph (iii) of the description B in the definition "hybrid surplus" in subsection 5907(1). An amount is included under this subparagraph if a subject affiliate (FA1) would have a capital loss on the disposition of the shares of another foreign affiliate of Canco if the subject affiliate's proceeds of disposition of the disposed shares were determined under subclause 95(2)(e)(iv)(A)(II), read without reference to its sub-subclause 1, and section 93 of the Act were read without reference to subsection 93(4). In this example, the amount determined under sub-subclause 95(2)(e)(iv)(A)(II)2 would be C$600 (i.e. the amount that would be determined under clause 95(2)(e)(iv)(B)) and, because FA1's proceeds of disposition of its FA2 shares would be C$600, FA1 would have a capital loss of C$400 on the disposition of its FA2 shares. Thus, although FA1 does not realize a FACL, this loss amount must still be deducted from FA1's hybrid surplus (or added to hybrid deficit) balance in respect of Canco.

However, if the surplus balances of FA1 are not maintained in Canadian dollars, the capital loss must be converted to the appropriate currency based on the exchange rate prevailing at the time of the disposition of the FA2 shares, as per new subsection 5907(5.01).

Rules for computing income, gains and losses

ITA
95(2)(*f.11*) to (*f.15*)

Paragraphs 95(2)(*f.11*) to (*f.15*) of the Act provide application rules for the purposes of the foreign affiliate income, gain and loss computation rules in paragraph 95(2)(*f*) of the Act.

ITA
95(2)(*f.11*)

Paragraph 95(2)(*f.11*) of the Act contains reading rules and deeming rules for the purposes of paragraph 95(2)(*f*).

Subparagraph 95(2)(*f.11*)(i) applies in respect of capital gains and losses of a foreign affiliate, as required to be computed under subparagraph 95(2)(*f*)(i).

Subparagraph 95(2)(*f.11*)(i) is being amended to add special rules in the context of capital gains and losses of a foreign affiliate from foreign currency fluctuations, as contemplated by amended subsection 39(2) of the Act, and from market fluctuations, as contemplated by subsection 39(3). New clause (B) deems any subsection 39(2) or (3) capital gains and losses that arise in respect of debt obligations owing by a relevant debtor to be dispositions of property held by the debtor during the time the debt obligation was owed.

The amendments to subparagraph 95(2)(*f.11*)(i) of the Act – together with the amendment of subsection 39(2) of the Act which, among other things, creates a separate capital gain or loss for each "gain made" or "loss sustained" by a foreign affiliate – are being made to ensure that the "carve-out" rule in paragraph 95(2)(*f.1*) applies in respect of capital gains and losses from debt obligations of a foreign affiliate. Thus, any such capital gains and losses that accrue prior to the foreign affiliate becoming a "specified person or partnership" (as defined in subsection 95(1)) in respect of the taxpayer are to be carved-out in determining the amount of a capital gain or loss under subparagraph 95(2)(*f*)(i). (For more information on the amendment to subsection 39(2) of the Act, refer to the above commentary for that provision.)

Subparagraph 95(2)(*f.11*)(ii) applies in respect of income or loss from property and non-active businesses of a foreign affiliate, as required to be computed under subparagraph 95(2)(*f*)(ii).

Subparagraph 95(2)(*f.11*)(ii) is being amended to add a new clause (C) that will perform a similar function to new clause 95(2)(*f.11*)(i)(B), as discussed above, but in respect of gains and losses on income account that arise in the context of businesses other than active businesses and non-qualifying businesses carried on, and property held, by a foreign affiliate.

These amendments apply in respect of foreign affiliate taxation years that end after Announcement Date.

ITA
95(2)(*f.12*)

Paragraph 95(2)(*f.12*) of the Act sets out various computations that are required to be made in a foreign affiliate's "calculating currency" (as defined in subsection 95(1)). Subparagraph (i) of that paragraph deals with capital gains and losses from the disposition of "excluded property" (as defined in subsection 95(1)).

Subparagraph 95(2)(*f.12*)(i) is being amended to require the determination of "excluded property" status to be made without reference to paragraph 95(2)(*i*) of the Act. The latter paragraph deems, among other things, certain gains and losses of a foreign affiliate from the disposition of certain debt obligations to be from dispositions of “excluded property”. This amendment, along with the amendment to paragraph 95(2)(*f.15*) that is discussed below, is intended to clarify the application of paragraphs 95(2)(*f*) and (*i*) in the context of foreign currency gains and losses in respect of certain debt obligations of a foreign affiliate.

These amendments apply in respect of foreign affiliate taxation years that end after Announcement Date.

ITA
95(2)(*f.14*)

Paragraph 95(2)(*f.14*) of the Act provides a catch-all rule that requires all income, gains and losses of a foreign affiliate to be computed in Canadian currency unless they are covered by paragraphs 95(2)(*f.12*) or (*f.13*).

Paragraph 95(2)(*f.14*) is being amended as a consequence of the amendments to paragraphs 95(2)(*f.12*) and (*f.15*) to add a reference to the latter paragraph.

These amendments apply in respect of foreign affiliate taxation years that end after Announcement Date.

ITA
95(2)(*f.15*)

Paragraph 95(2)(*f.15*) of the Act provides a “reading rule” for the application of subsection 39(2) of the Act where a foreign affiliate is required to determine the foreign exchange gains and losses contemplated by that subsection in its “calculating currency”, as provided by current subparagraph 95(2)(*f.12*)(i).

Paragraph 95(2)(*f.15*) is being amended, along with paragraph 95(2)(*f.12*), as discussed above, in order to clarify the application of paragraphs 95(2)(*f*) and (*i*) in the context of foreign currency gains and losses in respect of debt obligations of a foreign affiliate. Amended paragraph 95(2)(*f.15*) makes direct reference to the types of amounts owing by a foreign affiliate, as set out in subparagraphs 95(2)(*i*)(i) and (ii), that are intended to be subject to the “calculating currency” rules for computing gains and losses. This is aimed at removing the circularity in the determination of the quantum or existence of a gain or loss from foreign currency fluctuations in respect of those types of amounts owing.

Paragraph 95(2)(*f.15*) is also being amended consequential to the amendments to subsection 39(2) of the Act, which are discussed above. In particular, a reading rule is being added for the definition “foreign currency debt” in subsection 111(8), as that definition applies for the purposes of subsection 39(2).

As a result of these amendments, it should now be clear that the determination of such gains and losses is to be done in the following order:

- First, the taxpayer establishes that it has an amount owing that is covered by subparagraph 95(2)(*i*)(i) or (ii);
- Second, the reading rule in paragraph 95(2)(*f.15*) applies to replace references in subsection 39(2) to "Canadian currency" with references to "calculating currency";
- Third, the gain or loss under subparagraph 95(2)(*f*)(i) is determined using the special reading of subsection 39(2); and
- Fourth, the carve-out rule in paragraph 95(2)(*f.1*) is applied.

These amendments apply in respect of foreign affiliate taxation years that end after Announcement Date.

Foreign exchange gains and losses

ITA
95(2)(*g*)

Paragraph 95(2)(*g*) of the Act deems certain foreign exchange gains and losses realized by a foreign affiliate to be nil. Among other things, this provision applies to foreign exchange gains and losses of a foreign affiliate that arise on the redemption of its shares, or the reduction of its capital, pursuant to subparagraph (ii).

Subparagraph 95(2)(*g*)(ii) is being amended to remove the reference to a redemption, cancellation or acquisition of shares by the issuing affiliate. This amendment is consequential to the amendment to subsection 39(2) of the Act that ensures that an issuing corporation can only realize foreign exchange gains and losses in respect of its debt obligations and not in respect of its shares.

Subparagraph 95(2)(*g*)(ii) is also being amended to remove the reference to a reduction of capital of a foreign affiliate. This amendment is consequential to the amendment to paragraph 53(2)(*b*) of the Act, as discussed above, which eliminates the concept of a return of capital by a foreign affiliate.

These amendments apply in respect of foreign affiliate taxation years that end after Announcement Date.

Subsection 39(2) and excluded property

ITA
95(2)(*g.02*)

Paragraph 95(2)(*g.02*) of the Act provides that, in applying subsection 39(2) in the computation of gains and losses of a foreign affiliate, those gains and losses that are in respect of excluded property are to be computed separately from gains and losses in respect of non-excluded property.

Paragraph 95(2)(*g.02*) is being repealed as a consequence of the amendments to subsection 39(2) which, among other things, will require that each foreign exchange capital gain or loss of a foreign affiliate be determined separately.

The repeal of paragraph 95(2)(*g.02*) applies in respect of foreign affiliate taxation years that end after Announcement Date.

Insurance businesses

ITA
95(2)(*j.1*) and (*j.2*)

New paragraphs 95(2)(*j.1*) and (*j.2*) of the Act are being added to ensure that a foreign affiliate that carries on an insurance business, whether directly or through a partnership, is eligible to claim certain policy reserves in computing its foreign accrual property income. These rules have many similarities to the “fresh start” rules in paragraphs 95(2)(*k*) and (*k.1*), as discussed below, but one important difference is that the (*j.1*) and (*j.2*) rules can apply regardless of whether the insurance business went through a transition from active to passive.

These new paragraphs apply to foreign affiliate taxation years that begin after December 20, 2002. However, taxpayers may elect to have these rules, as well as the “fresh start” rules in paragraphs 95(2)(*k*) and (*k.1*), apply to foreign affiliate taxation years that begin after 1994.

Fresh start rules

ITA
95(2)(*k*) and (*k.1*)

Paragraph 95(2)(*k*) provides rules that apply to a foreign affiliate in respect of a business (the “foreign business”) that is considered to be an investment business as defined in subsection 95(1) or a separate business other than an active business under paragraphs 95(2)(*a.1*), (*a.2*), (*a.3*) or (*a.4*). It provides rules for computing the income of the affiliate from the foreign business for the first and subsequent taxation years in which such business is considered to be carried on.

These so-called “fresh start” rules ensure that income or losses accruing in prior periods do not enter into the income calculations for the foreign business in the particular taxation year or in subsequent taxation years. This is done, in part, by deeming a disposition and reacquisition of property used or held in the foreign business immediately before the beginning of the particular taxation year. These deemed disposition rules also provide a starting point to transition the computation of the income from the foreign business to Canadian tax rules. There is also a specific rule that deems the foreign affiliate to be subject to the supervision of a regulating authority in order to permit the foreign affiliate to claim certain reserves in respect of insurance policies in connection with the foreign business.

A number of amendments are being made to these fresh start rules. In particular, paragraph 95(2)(*k*) is being divided into two paragraphs, 95(2)(*k*) and (*k.1*). Amended paragraph (*k*) defines the circumstances in which the fresh start rules apply, and new paragraph (*k.1*) contains the substantive provisions of the fresh start rules. The substantive amendments to the fresh start rules can be summarized as follows:

- First, the amendments ensure that the fresh start rules apply not only if the particular business is carried on by a foreign affiliate of a taxpayer, but also if the particular business is carried on by a partnership of which a foreign affiliate is a member. These amendments ensure, in the case of partnerships, that the fresh start rules will work on the basis of fiscal periods of the partnership and will therefore be relevant in the computation of the foreign affiliate's foreign accrual property income for the foreign affiliate's taxation year that includes a fiscal period to which the fresh start rules apply. In these paragraphs, the expression “operator” refers to the foreign affiliate (if the foreign affiliate directly carries on the particular business) or to the partnership (if the foreign affiliate carries on the particular business through the partnership).

- Second, the amendments ensure that the fresh start rules are no longer triggered if the operator begins to carry on the particular business in the specified taxation year, i.e. where it did not carry on the particular business in the preceding taxation year. In other words, there has to be a transition, whether by way of the business changing its nature or by the non-resident corporation becoming a foreign affiliate of the taxpayer, in order for the fresh start rules to apply. However, it is possible that, in situations where there is no transition, new paragraphs 95(2)(*j.1*) and (*j.2*) may apply. For further detail, see the commentary to those new paragraphs.

- Third, the amendments expand the types of businesses to which these rules apply to include a non-qualifying business (as defined in subsection 95(1)) and businesses to which either paragraph 95(2)(*b*) or (*l*) applies.

- Fourth, new paragraph 95(2)(*k*) introduces an exception for a “taxable Canadian business”. This exception is being introduced because there is no need for a “fresh start” transition of such a business to Canadian tax rules – it is already subject to

Canadian tax rules. For more details, see the above commentary for the new definition "taxable Canadian business" in subsection 95(1).

- Fifth, new paragraph 95(2)(*k.1*) provides (in clause (ii)(B)) a new deeming rule for life insurance businesses. The deeming rule allows certain policy reserves to be claimed by deeming life insurance policies issued in the conduct of the business to be life insurance policies in Canada.

- Sixth, new paragraph 95(2)(*k.1*) clarifies (in clause (iii)(D)) the intended link to paragraph 138(11.91)(*e*) of the Act.

- Finally, as a consequence of the repeal of paragraph 138(11.91)(*f*) of the Act, the reference in current subparagraph 95(2)(*k*)(v) to paragraph 138(11.91)(*f*) of the Act is removed from new subparagraph 95(2)(*k.1*)(iii).

New paragraphs 95(2)(*k*) and (*k.1*) apply to foreign affiliate taxation years that begin after December 20, 2002. However, taxpayers can elect to have them, as well as new paragraphs 95(2)(*j.1*) and (*j.2*) and the new definition "taxable Canadian business" in subsection 95(1), apply to all of their foreign affiliates for foreign affiliate taxation years that begin after 1994. There are also a number of transitional rules.

Note also that subclause 16(17) of these legislative proposals ensures that the "life insurance policies in Canada" deeming rule applies for foreign affiliate taxation years ending after 1999 regardless of whether the taxpayer makes the retroactive election to have all of the paragraph 95(2)(*j.1*) to (*k.1*) rules apply from 1995 forward. Where the latter election is not made, this rule will be contained in clause 95(2)(*k*)(iv)(B), as enacted by subclause 16(17), and applicable for foreign affiliate taxation years ending after 1999; where it is made, subclause 16(17) will be overridden by subclause 16(18) which will enact the same rule in clause 95(2)(*k.1*)(ii)(B) of the Act, applicable to foreign affiliate taxation years beginning after 1994. In either case, clause 95(2)(*k.1*)(ii)(B), as enacted by subclause 16(18), will apply to foreign affiliate taxation years that begin after December 20, 2002.

Deemed separate business

ITA
95(2)(*k.2*)

New paragraph 95(2)(*k.2*) is an interpretive rule for the purposes of paragraphs 95(2)(*j.1*) to (*k.1*) and the definition "taxable Canadian business" in subsection 95(1) of the Act. It applies in situations where it may otherwise be considered that operations carried on partly in Canada and partly outside Canada form a single business of a foreign affiliate. In order to make the rules in paragraphs 95(2)(*j.1*) to (*k.1*) apply properly, any part of such a business that is carried on in Canada is, under paragraph 95(2)(*k.2*), deemed to be a separate business.

New paragraph 95(2)(*k.2*) applies on the same basis as the amendments to paragraphs 95(2)(*j.1*) to (*k.1*), as discussed above.

Look-through rule for partnerships

ITA
95(2)(*u*)

Paragraph 95(2)(*u*) of the Act contains two “look-through” rules to deal with cases where one partnership (i.e. an upper-tier partnership) is a member of another partnership (i.e. a lower-tier partnership). The look-through rules apply for the purposes of certain specified provisions in subsection 95(1). The rule in subparagraph 95(2)(*u*)(i) deems a member of an upper-tier partnership to be a member of the lower-tier partnership. The rule in subparagraph 95(2)(*u*)(ii) deems a member of the upper-tier partnership to have certain rights to the income and capital of the lower-tier partnership.

Paragraph 95(2)(*u*) is first being amended, retroactively, in order to incorporate appropriate references to the insurance business and fresh start rules that are discussed above (paragraphs 95(2)(*j.1*) to (*k.2*)), and then it is being repealed, for foreign affiliate taxation years that end after Announcement Date, as its functions are being taken over by new subsection 93.1(3).

Amended paragraph 95(2)(*u*) applies to foreign affiliate taxation years that begin after December 20, 2002. This amended paragraph can also apply even farther back in time (i.e. for foreign affiliate taxation years that begin after 1994) where an election is made in the context of the fresh start rules in amended paragraphs 95(2)(*k*) to (*k.2*), as discussed above.

Definitions

ITA
95(4)

Subsection 95(4) of the Act defines certain expressions that are used in section 95.

“relevant cost base”

Currently, “relevant cost base” or “RCB” to a foreign affiliate of a property is defined to mean the adjusted cost base of the property or such greater amount as the taxpayer claims not exceeding the fair market value of the property. RCB is used in the current versions of paragraphs 95(2)(*c*), (*d*) and (*e*) of the Act.

As noted above, this definition will now also be used in paragraphs 88(3)(*a*) and 95(2)(*d.1*).

RCB is being amended to reflect the expansion of various foreign affiliate rollover rules, as noted above, to non-capital property. Thus, the previous reference to “adjusted cost base” is being replaced with a more flexible concept that refers to the cost of the property that is relevant to the foreign affiliate rules in the Act, i.e. the amount for which a property could be disposed of that would not result in any gain or loss. For some properties this cost will be based on Canadian tax rules, for others it will be based on foreign tax law. For those properties for which the so-called “carve-out” rule in paragraph 95(2)(*f.1*) is relevant, the RCB of the property will also take that rule into account. This could either increase or decrease the cost otherwise determined.

RCB is also being amended so that the ability to elect a higher amount is limited to property owned by an eligible controlled foreign affiliate of a taxpayer, which essentially is a controlled foreign affiliate in which the taxpayer has a participating percentage of at least 90%.

These amendments to RCB apply as of February 27, 2004. However, they can apply earlier, for limited purposes, where certain retroactive elections are made in respect of the new rollover provisions discussed above. There are also transitional rules to give effect to previously announced legislative proposals in this regard.

“eligible controlled foreign affiliate”

The definition “eligible controlled foreign affiliate” is added to subsection 95(4). See the comments under “relevant cost base” for details.

This new definition applies on the same basis as the amendments to “relevant cost base”.

Absorptive mergers

ITA
95(4.2)

New subsection 95(4.2) of the Act clarifies the circumstances in which certain foreign “absorptive mergers” will qualify as “foreign mergers” for the purposes of section 95 of the Act and Part LIX of the Regulations. This rule is mainly designed to ensure that certain common forms of U.S. mergers qualify for the rollover provisions that are provided for in the foreign affiliate rules.

This new subsection applies in respect of mergers or combinations that occur after 1994. However, taxpayers may elect to have it apply only in respect of mergers or combinations that occur after Announcement Date.

Clause 17

Deduction in respect of dividend received from foreign affiliate

ITA
113(1)

Subsection 113(1) of the Act permits a corporation resident in Canada to deduct specified amounts in respect of dividends received from a foreign affiliate out of the exempt, taxable and pre-acquisition surpluses of the foreign affiliate. The amounts so deductible are determined largely with reference to Part LIX of the Regulations.

Subsection 113(1) is being amended consequential to the introduction of the new "hybrid surplus" concept discussed in the overview section of these notes. New paragraph 113(1)(*a.1*) allows a corporation to deduct one-half of any dividends paid out of hybrid surplus plus an additional amount in respect of "hybrid underlying tax" and withholding tax. The mechanics for the additional deduction are similar to those for taxable surplus, with one important difference: the gross-up for underlying tax is based on the relevant tax factor minus one-half.

New paragraph 113(1)(*a.1*) applies to dividends received after Announcement Date.

Example

Assumptions

1. *Canco, a corporation resident in Canada, owns 100% of the shares of FA1, a non-resident corporation. Canco's adjusted cost base ("ACB") in the FA1 shares is nominal. Canco has owned these shares since FA1 was incorporated.*

2. *FA1 owns, and has always owned, 100% of the shares of FA2, also a non-resident corporation. FA1's ACB of the FA2 shares is $1,000 and the shares have a fair market value of $1,500.*

3. *On June 30, 2012, FA1 sells all of the shares of FA2 to Canco for cash proceeds of $1,500.*

4. *The shares of FA2 are excluded property, as defined in subsection 95(1), at the time of their sale to Canco.*

5. *FA1's capital gain of $500 is subject to foreign income tax of $50.*

6. *On July 1, 2012, FA1 pays a cash dividend of $450 to Canco. No foreign withholding tax is levied in respect of the dividend.*

7. *Immediately prior to the sale of the FA2 shares by FA1 to Canco, neither FA1 nor FA2 had any surplus or deficit balances in respect of Canco.*

8. *Canco's tax rate for its 2012 taxation year is 25%.*

Analysis

Since no portion of FA1's capital gain on the disposition of the FA2 shares is included in FAPI (because the shares are excluded property), FA1's capital gain of $500 is included in its hybrid surplus at the time of the disposition. In addition, the $50 of foreign income tax paid by FA1 is included in FA1's hybrid underlying tax and reduces FA1's hybrid surplus.

The $450 dividend paid by FA1 on July 1, 2012 is deemed to be paid out of FA1's hybrid surplus. As such, Canco will entitled to the following deductions under paragraph 113(1)(a.1):

<u>113(1)(a.1)(i)</u>			
50% x $450			*$225*
<u>113(1)(a.1)(ii)</u>			
The lesser of:	*(A) $50 x 3.5 [being (1/0.25) – 0.5]; and*	*$175*	
	(B) the amount determined in (a.1)(i)	*225*	*<u>$175</u>*
Total paragraph 113(1)(a.1) deductions			*<u>$400</u>*

It is notable that if the $500 gain in this example had been subject to the pre-Announcement Date regime whereby 50% of the capital gain would be included in FA1's exempt surplus and 50% in taxable surplus (with the $50 included in FA1's underlying foreign tax and reducing taxable surplus), the subsection 113(1) deductions in respect of a total distribution by FA1 of the resulting exempt and taxable surplus balances would also aggregate $400, as follows:

<u>113(1)(a)</u>			*$250*
<u>113(1)(b)</u>			
The lesser of:	*(i) $50 x 3 [being (1/0.25) – 1]; and*	*$150*	
	(ii) the taxable surplus dividend	*200*	*<u>$150</u>*
Total subsection 113(1) deductions			*<u>$400</u>*

It is also noteworthy that, under the hybrid surplus regime, if the foreign tax rate in respect of the capital gain had been one-half of the 25% Canadian tax rate, i.e. equal to the Canadian capital gains rate, such that hybrid underlying tax would be $500 x 12.5% = $62.50 and hybrid surplus would be $500 – $62.50 = $437.50, the relevant numbers would be as follows:

113(1)(a.1)(i)			
50% x $437.50			*$218.75*
113(1)(a.1)(ii)			
The lesser of:	*(A) $62.50 x 3.5 [being (1/0.25) – 0.5]; and*	*$218.75*	
	(B) the amount determined in (a.1)(i)	*218.75*	*$218.75*
Total paragraph 113(1)(a.1) deductions			*$437.50*

The result in such a case is a full deduction for the hybrid surplus dividend.

Additional deduction

ITA
113(2)

Subsection 113(2) of the Act is a transitional provision that essentially permits a corporation resident in Canada that owned shares of a foreign affiliate at the end of the corporation's 1975 taxation year to have certain dividends reduce the adjusted cost base ("ACB") of the shares rather than be included in taxable income. Subsection 113(2) provides for the deduction from taxable income, and subsection 92(3) provides for the ACB reduction.

Subparagraph 113(2)(*b*)(iii.1), which reduces the amount otherwise allowable under subsection 113(2) by any paid-up capital reductions received before the relevant time, is being amended as a consequence of the new treatment of distributions from a foreign affiliate, as discussed above under the commentary to paragraph 53(2)(*b*) and subsections 90(2) and (3).

This amendment applies after Announcement Date.

Clause 18

Changes in residence - immigration

ITA
128.1(1)

Subsection 128.1(1) of the Act provides rules that apply when a taxpayer becomes resident in Canada. Paragraph 128.1(1)(*d*) sets out rules that apply where the immigrating taxpayer was, immediately before its immigration into Canada, a foreign affiliate of another taxpayer resident in Canada.

Paragraph 128.1(1)(*d*) is amended to update the manner in which it refers to "controlled foreign affiliate" and "foreign accrual property income", consequential to the addition of those definitions to subsection 248(1) of the Act.

This amendment applies to taxation years that begin after 2006.

Clause 19

Reassessment if amount under subsection 91(1) is reduced

ITA
152(6.1)

Subsection 152(6.1) of the Act provides for the reassessment of a taxpayer in certain circumstances where a "foreign accrual property loss" of a foreign affiliate of the taxpayer is carried back.

Subsection 152(6.1) is being amended to reflect the introduction of the new concept of a "foreign accrual capital loss", which also allows for a carryback. For more details, refer to the commentary to new section 5903.1 of the Regulations.

This amendment applies after Announcement Date.

Clause 20

Assessable dividend

ITA
186(3)

Subsection 186(3) of the Act defines the expression "assessable dividend" for the purposes of the special tax levied on dividends under Part IV of the Act.

Subsection 186(3) is being amended, consequential to the introduction of the "hybrid surplus" concept, to add a reference to new paragraph 113(1)(*a.1*) of the Act.

In addition, the French version of the Act is being amended to replace the term "dividende déterminé" in section 186 with the term "dividende imposable déterminé".

These amendments apply after Announcement Date.

Clause 21

Deemed interest on certain shares - exceptions

ITA
258(4) and (6)

Subsections 258(3) and (5) of the Act provide rules that deem, in certain circumstances, certain dividends to be interest received by a taxpayer.

Subsection 258(4), which provides exceptions to subsection 258(3), is being amended to add an additional exception; and new subsection 258(6) is being added to provide a new exception to subsection 258(5). Both new exceptions carve-out any returns of paid-up capital received from a foreign affiliate as such returns are now to be treated as dividends (as per new subsection 90(2)) and it is not appropriate to subject these types of dividends to the deemed interest rules of subsections 258(3) and (5).

These amendments apply to dividends paid after Announcement Date.

Clause 22

Functional currency tax reporting

ITA
261(5)

Subsection 261(5) of the Act provides a number of rules for taxpayers that have elected under the functional currency tax reporting regime.

Paragraph 261(5)(*e*) provides a "reading rule" for the purposes of subsection 39(2) of the Act. This reading rule replaces, effectively, references to Canadian currency in that subsection with references to the taxpayer's elected functional currency.

Subparagraph 261(5)(*f*)(i) provides reading rules for various provisions of the Act and the Regulations. Those reading rules replace references to "Canadian currency" with references to the taxpayer's elected functional currency.

Two amendments are being made to subsection 261(5):

First, paragraph 261(5)(*e*) is being amended consequential to the amendments to subsection 39(2) of the Act which, among other things, simplify the “currency” references in that subsection.

Second, subparagraph 261(5)(*f*)(i) is being amended to add new subsections 93(2.01) to (2.31) to its listed provisions, as those new subsections contain references to Canadian currency. For more details, see the above commentary relating to new subsections 93(2) to (2.32) of the Act.

The first amendment applies in respect of gains made and losses sustained in taxation years that begin after Announcement Date. The second amendment applies to taxation years that begin after December 13, 2007.

Converting Canadian currency amounts

ITA
261(7)

Subsection 261(7) of the Act sets out various rules for converting tax attributes from Canadian currency to a taxpayer’s elected functional currency, where a taxpayer has elected into the functional currency tax reporting regime. Paragraph 261(7)(*a*) deals with loss and other similar carryforward balances.

Subparagraph 261(7)(*a*)(i) is being amended to add a reference to variable F.1 in the FAPI definition. This amendment is consequential to the introduction of the new concept of a foreign accrual capital loss. For more details, see the commentary below relating to new section 5903.1 of the Regulations.

This amendment applies after Announcement Date.

Income Tax Regulations

Clause 23

Dividends out of various surplus accounts

ITR
5900

Section 5900 is the main “gateway” to Part LIX of the Regulations. Its primary function is to prescribe the amounts that are deductible by a corporation resident in Canada under section 113 of the Act in respect of dividends from a foreign affiliate. Section 5900 is the section that makes relevant the concepts of exempt and taxable surplus (concepts that occupy a substantial portion of Part LIX of the Regulations) and pre-acquisition surplus.

ITR
5900(1)

Subsection 5900(1) is being amended to add new paragraphs (*a.1*) and (*c.1*) to take into account the new concept of "hybrid surplus", as discussed in the overview section of these notes and as newly defined in subsection 5907(1) of the Regulations, which is discussed below.

New paragraph 5900(1)(*a.1*) prescribes the amounts that are deductible by a corporation resident in Canada under new subparagraph 113(1)(*a.1*)(i) of the Act in respect of dividends from a foreign affiliate's hybrid surplus. New paragraph 5900(1)(*c.1*) prescribes the amount that is to be taken into account under new subparagraph 113(1)(*a.1*)(ii) of the Act as foreign tax applicable to the hybrid surplus portion of the dividend.

These amendments apply to dividends received after Announcement Date.

Clause 24

Order of surplus distributions

ITR
5901

Section 5901 of the Regulations sets out ordering rules in respect of a whole dividend paid by a foreign affiliate on its shares. Under those rules, a whole dividend is generally treated as having been paid out of exempt surplus (until that surplus is exhausted), then taxable surplus (until that surplus is exhausted), then pre-acquisition surplus.

Section 5901 is amended in a number of ways to reflect the introduction of the new concept of "hybrid surplus" and the new election in respect of pre-acquisition surplus dividends, which are both referred to above in the overview section of these notes.

The subsection 5901(1) amendments are consequential to the introduction of "hybrid surplus". These amendments provide the default rule whereby hybrid surplus is deemed to be distributed after exempt surplus but before taxable surplus. However, in recognition of the possibility that taxable surplus may in some cases be more valuable to a taxpayer than hybrid surplus, new subsection 5901(1.1) is added in order to give taxpayers the ability to elect, in respect of a particular whole dividend, to have taxable surplus come out before hybrid surplus. Because the deficit offset rules are based on deficits being applied to the most valuable surplus balances first, this "switch-over" election requires a reordering of those deficit offset rules.

Subsection 5901(2), which contains the so-called "90-day rule" is amended and restructured. The content of current subsection 5901(2) is being moved into new paragraph (*a*). This paragraph now also incorporates references to "hybrid surplus", and related concepts, as well as a carve-out for pre-acquisition surplus dividends that would arise from an election under paragraph (*b*).

New paragraph 5901(2)(*b*) allows taxpayers to elect to "side-step" the normal ordering rules of subsection 5901(1) and instead have a whole dividend deemed to be paid out of pre-acquisition surplus. This election is meant to allow taxpayers to access their capital first as measured by the adjusted cost base ("ACB") of the shares rather than a legal notion of paid-up capital. The amount elected is not limited to the ACB of the shares and thus can cause ACB to become negative. However, any gain created under subsection 40(3) will, as discussed above, be subject to a forced subsection 93(1) election, by virtue of new paragraph 93(1.1)(*b*) and new subsection 93(1.11). This will ensure that taxpayers cannot use this new pre-acquisition surplus election to convert low-taxed hybrid or taxable surplus into a capital gain.

It is also notable that all related Canadian companies in respect of which the dividend-paying corporation is a foreign affiliate must jointly make the election. However, a special reading of the definition "equity percentage" in subsection 95(4), which is a key determinant of foreign affiliate status, applies to ensure that it is only the bottom company in a chain of Canadian corporations that need be included in the election. In other words, the dividend-paying corporation will not be considered, for these purposes, to be a foreign affiliate of a Canadian corporation that has no direct ownership of the dividend-paying corporation but that owns the shares of another Canadian corporation that owns the shares of the dividend-paying corporation.

Because of the special deferred treatment given to pre-acquisition surplus dividends paid on foreign affiliate shares held by a partnership (as per subsections 92(4) to (6) of the Act), this new election is not available where any electing corporation (as described in subparagraph 5901(2)(*b*)(i)) is a member of a partnership and that partnership is a shareholder of the dividend-paying foreign affiliate.

These amendments generally apply to dividends paid after Announcement Date. However, taxpayers may elect that the pre-acquisition surplus election rules apply to dividends paid after February 27, 2004. In such cases, a transitional reading of paragraph 5901(2)(*a*) is provided in order to remove the references relating to hybrid surplus concepts.

Example

Assumptions

1. *Canco, a corporation resident in Canada, owns 60 of the 100 common shares of FA, a non-resident corporation. The 40 other common shares of FA are owned by an arm's length person.*

2. *On June 15, 2012, FA pays a dividend of $1,000, $600 of which is paid to Canco.*

3. *Immediately prior to the dividend payment,*

    a. *FA has an exempt surplus balance of $200, a taxable surplus balance of $400, an underlying foreign tax balance of $40, and no other surplus/deficit balances, in respect of Canco; and*

    b. *the adjusted cost base ("ACB") to Canco of its 60 shares of FA was $350.*

4. *No foreign withholding tax is imposed on the payment of the $1,000 dividend.*

Analysis

If no election is made under new paragraph 5901(2)(b), $200 of the dividend will be deemed to be paid out of exempt surplus, $400 out of taxable surplus, and $400 from pre-acquisition surplus. Thus, Canco will be entitled to a $120 deduction under paragraph 113(1)(a) for its portion of the exempt surplus dividend and, assuming a tax rate of 25%, a $72 deduction under paragraph 113(1)(b) for its $240 portion of the taxable surplus dividend, resulting in a net taxable income inclusion of $168. The remaining $240 portion of the dividend paid to Canco will be deemed paid out of pre-acquisition surplus and will reduce Canco's ACB of the FA shares to $110.

If Canco does elect under paragraph 5901(2)(b), its $600 portion of the $1,000 dividend will be deemed to come entirely out of pre-acquisition surplus. This will result in a negative ACB of $250 causing a capital gain to Canco under subsection 40(3). However, new paragraph 93(1.1)(b), in conjunction with new subsection 93(1.11), will deem Canco to have made a subsection 93(1) election, and in this example to have designated in that election a prescribed amount of $250. The resulting $250 deemed dividend will be prescribed to be a $120 dividend paid out of the exempt surplus of FA and a $130 dividend paid out of taxable surplus, which results in deductions of $120 and $39 under paragraphs 113(1)(a) and (b), respectively, and a net taxable income inclusion of $91.

Thus, as a result of this new pre-acquisition surplus election, Canco is able to reduce its net taxable income inclusion in respect of the dividend from $168 to $91 by first reducing its "capital" to zero. (Note that this example ignores the possibility of making a so-called "disproportionate UFT" election under paragraph (b) of the definition "underlying foreign tax applicable" in subsection 5907(1).)

Clause 25

Subsection 93(1) elections

ITR
5902

Section 5902 of the Regulations sets out various rules that apply in the context of a subsection 93(1) election, i.e. an election to reduce the capital gain realized by a taxpayer, or another foreign affiliate of a taxpayer, on a disposition of the shares of a foreign affiliate.

ITR
5902(1)

Subsection 5902(1) of the Regulations computes, in its paragraph (*a*), a foreign affiliate's surplus accounts and the amount of a whole dividend that are used in applying subsection 5901(1) for the purposes of subsection 5900(1), in the context of a subsection 93(1) election. It also provides, in its paragraph (*b*), for surplus reductions to account for the dividends that are deemed to be paid as a result of such an election.

Paragraphs (*a*) and (*b*) of subsection 5902(1) are each being amended, consequential to the introduction of the "hybrid surplus" rules, to add references to the relevant hybrid surplus concepts.

These amendments apply to relevant dispositions that occur after Announcement Date.

ITR
5902(2)

Subsection 5902(2) of the Regulations provides some interpretive rules for the purposes of paragraph 5902(1)(*a*). One of those rules, the one found in subparagraph 5902(2)(*a*)(i), is meant to address situations where foreign affiliate groups have circular shareholdings, i.e. one foreign affiliate owns shares in another foreign affiliate, which in turn owns shares in the first-mentioned affiliate, directly or indirectly.

Subparagraph 5902(2)(*a*)(i) is being amended to clarify its intended application. Essentially the current mechanical rule is being replaced with a more conceptual one. The intent of this rule is to provide results that simulate what would happen if a series of actual dividends had been paid all the way up the relevant foreign affiliate chain and back down and repeated a sufficient number of times in order to establish a reasonably accurate measure of the taxpayer's entitlement to earnings of the group.

Subparagraph 5902(2)(*a*)(ii) is being amended to modernize its language.

These amendments apply to relevant dispositions that occur after Announcement Date.

Example

Assumptions

1. *Canco is a corporation resident in Canada. FA1 is a non-resident corporation.*

2. *Canco owns 50 of the 100 shares of FA1's only class of capital stock. Canco's aggregate adjusted cost base of those 50 shares is $50.*

3. *FA1 owns 50 of the 100 shares of FA2's only class of capital stock. FA2 is also a non-resident corporation.*

4. *FA2 owns the other 50 shares of FA1.*

5. *An arm's length person owns the remaining 50 shares of FA2.*

6. *Canco sells its 50 shares of FA1 for $400 and wishes to make a subsection 93(1) election to reduce its $350 gain.*

7. *Immediately prior to the sale:*

    a. *FA1 has an exempt surplus balance of $200, and no other surplus balances, in respect of Canco; and*

    b. *FA2 has an exempt surplus balance of $100, and no other surplus balances, in respect of Canco.*

Analysis

Under amended paragraph 93(1)(a) of the Act, Canco can elect a dividend of up to $350. In this example, it is assumed that Canco elects that maximum amount.

Subsection 5902(1) of the Regulations applies to determine the treatment of that $350 elected dividend under subsection 5900(1) (which in turn determines section 113 treatment) by deeming FA1's surplus for the purposes of subsection 5901(1) to be an aggregate of the surplus of FA1 and FA2. More specifically, subparagraph 5902(1)(a)(i) provides that for purposes of an elected subsection 93(1) dividend, FA1's exempt surplus is deemed to include the amount of FA2's exempt surplus that FA1 would have received if, immediately before the elected dividend time, FA2 had paid a dividend equal to its exempt (net) surplus. This rule works appropriately in most circumstances but not where multiple dividends from the same foreign affiliates need to be contemplated in order to arrive at a proper measure of surplus entitlement, as is the case with circular shareholdings. The special rules of subparagraph 5902(2)(a)(i) are meant to help interpret the rules of subparagraph 5902(1)(a)(i) in these situations.

More specifically, amended subparagraph 5902(2)(a)(i) provides, in circular shareholding situations, that the determination of the amount of FA1's exempt surplus is to be made in a manner that is both reasonable in the circumstances and consistent with the results that would be obtained if a series of actual dividends had been paid by FA1 and FA2. In this example, it is necessary to assume a number of dividends to be paid by both FA1 and FA2 in order to arrive at the proper exempt surplus balance of FA1 to be used in the determination of Canco's deduction under paragraph 113(1)(a).

This determination could start with an assumed dividend of $100 paid by FA2 (of which $50 would be paid to FA1), followed by an assumed dividend of $250 paid by FA1 (of which $125 would be paid to FA2), followed by an assumed dividend of $125 paid by FA2, etc. Alternatively, the determination could start with an assumed dividend of $200 paid by FA1. Either approach should yield the same result.

Although theoretically these dividends would go in an endless loop, after only 2 or 3 "circles" a very good approximation of the proper result becomes evident. That is the intent of the rule – a reasonable result in the circumstances by reference to a series of hypothetical dividends. In this example it is reasonable that the amount determined under clause 5902(1)(a)(i)(A) as the dividend received by FA1 from FA2 should be $133, resulting in the amount of FA1's exempt surplus for the purposes of the subsection 93(1) election being determined to be $333. (Although the $333 is in excess of the $300 total surplus of FA1 and FA2, this is the amount that is necessary for the shares disposed of by Canco, being 50% of FA1's shares, to be entitled to their proper portion of exempt surplus, being $167).

The logic of this result can be verified by an analysis of Canco's economic interest in each of FA1 and FA2, being 67% in respect of FA1 and 33% in respect of FA2. Thus, Canco should be entitled to $134 (67% x $200) of FA1's exempt surplus and $33 (33% x $100) of FA2's exempt surplus, for a total of $167.

Under subparagraph 5902(1)(a)(ii), the "whole dividend" in respect of all the shares of FA1 is $700, which is effectively the $350 elected amount grossed-up for the 50% portion of the shares to which it relates. Subsection 5901(1) will classify this dividend as being $333 from exempt surplus, based on the exempt surplus computed above, and the remaining $367 as being from pre-acquisition surplus. Paragraph 5900(1)(a) will prescribe 333/700ths of the $7 deemed dividend in respect of each of the 50 shares disposed of to be from exempt surplus, such that Canco will be entitled to an aggregate paragraph 113(1)(a) deduction of $167. Paragraph 5900(1)(c) will prescribe 367/700ths of those $7 dividends to be from pre-acquisition surplus, which will result in a paragraph 113(1)(d) deduction of $183 and an ACB grind of the same amount, which will produce a net capital gain of $183.

Thus, Canco would, in this example, be able to reduce its $350 capital gain by $167 in respect of its entitlement to FA1's "group" exempt surplus.

These same principles in respect of circular shareholdings should apply for the purposes of amended paragraphs 5904(3)(b) and 5905(11)(a), which are discussed below.

ITR
5902(6)

Subsection 5902(6) of the Regulations prescribes the amount that is deemed to be elected under subsection 93(1) where subsection 93(1.1) applies.

Subsection 5902(6) is being amended, consequential to the restructuring of subsection 93(1.1), to refer to new subsection 93(1.11).

This amendment applies to relevant dispositions that occur after Announcement Date. However, it will apply earlier if the taxpayer elects retroactive application of the new pre-acquisition surplus election in paragraph 5901(2)(*b*).

Clause 26

Foreign accrual property losses

ITR
5903

Section 5903 of the Regulations sets out various rules that apply in the determination of a foreign affiliate's "foreign accrual property losses" ("FAPLs"). FAPLs are relevant in the computation of the foreign accrual property income ("FAPI") of a foreign affiliate, as per variable F of the FAPI definition in subsection 95(1) of the Act.

ITR
5903(3)

Subsection 5903(3) of the Regulations sets out the mechanics for determining the FAPL, for a taxation year, of a foreign affiliate of a taxpayer by reference to the variables in the FAPI definition in subsection 95(1) of the Act.

Paragraph 5903(3)(*a*) is being restructured in order to make it function better, to remove capital losses, and to incorporate appropriate references to deal with the amendments to variable E, and the addition of variable F.1, of the FAPI definition. Essentially, variable E amounts will no longer be included in FAPLs and will only be relevant, along with variable F.1 amounts, in determining how much of variable B capital gains are to be included in a FAPL determination. Variable E amounts will now become the principal component of foreign accrual capital losses, as discussed below under the commentary to new section 5903.1.

These amendments apply to foreign affiliate taxation years that end after Announcement Date.

ITR
5903(4)

Subsection 5903(4) of the Regulations prevents the double counting of FAPLs. It provides that FAPLs of one foreign affiliate will not include any of its losses for which certain other foreign affiliates have made compensatory payments where those other affiliates have claimed those payments as foreign accrual tax. This rule is aimed at foreign tax regimes which allow one company's losses to be used by another in determining their liability for foreign income tax, whether by way of consolidated tax returns or a more direct system of loss surrendering.

Subsection 5903(4) is being amended to eliminate the reference to variable E of the FAPI definition. This amendment is consequential to the introduction of FACLs and the addition of a parallel provision in new subsection 5903.1(4), as discussed below.

This amendment applies for foreign affiliate taxation years that end after Announcement Date.

ITR
5903(5)

Subsection 5903(5) of the Regulations provides for the flow-through of FAPLs upon certain foreign mergers or liquidations involving foreign affiliates.

Subsection 5903(5) is amended in two ways.

First, it is being amended to extend its application to section 5903.1, the new section that deals with FACLs.

Second, it is being amended to make direct reference to paragraphs 95(2)(*d.1*) and (*e*) of the Act thereby incorporating the conditions built into those provisions and removing the conditions that currently exist within subsection 5903(5). Furthermore, the flow-through rules are being clarified to ensure that FAPLs and FACLs of a new corporation or shareholder affiliate, as the case may be, cannot be carried back against FAPI of a predecessor or disposing affiliate.

(Note that there is no need to specifically refer to subsection 87(8.1) of the Act for the meaning of "foreign merger" as subsection 95(4) of the Act defines that term for the purposes of section 95 and section 5903 applies exclusively for the purposes of a provision within section 95, i.e. the FAPI definition in subsection 95(1).)

The first amendment applies to foreign affiliate taxation years that end after Announcement Date.

The second amendment applies on the same basis as the amendments to paragraphs 95(2)(*d.1*) and (*e*) of the Act, as discussed above (which allow for retroactive elections). However, transitional readings are provided to ensure that the clarifying FAPL and FACL carryback language applies prospectively.

ITR
5903(6)

Subsection 5903(6) of the Regulations defines the expression "relevant person or partnership" for the purposes of section 5903.

Subsection 5903(6) is being amended to extend its application to section 5903.1, which is the new section that deals with FACLs.

This amendment applies to foreign affiliate taxation years that end after Announcement Date.

Clause 27

Foreign accrual capital losses

ITR
5903.1

New section 5903.1 of the Regulations introduces the new concept of a "foreign accrual capital loss" or "FACL". Under current rules, FACLs are included in the determination of FAPLs in section 5903, which are deducted under variable F of the FAPI definition in subsection 95(1) of the Act. Some of the amendments to section 5903 that are discussed above have the effect of removing FACLs from FAPLs, and new section 5903.1 provides the rules for determining FACLs. FACLs feed into new variable F.1 of the FAPI definition. FAPLs and FACLs are the loss carryforward concepts applicable in the FAPI context. Current year "income" and "capital" losses are deducted under variables D and E of the FAPI definition.

This new FACL concept is part of an initiative to bring the foreign affiliate FAPI rules in line with the rules applicable to Canadian corporations, i.e. the rules that "stream" capital losses against capital gains. Essentially, FAPLs and FACLs will now have to be accounted for separately and FACLs, as well as the current year capital losses that are captured under variable E of the FAPI definition, will be limited to capital gains. For more details on these limitations, refer to the above commentary dealing with amended variable E and new variable F.1 of the FAPI definition in subsection 95(1) of the Act.

The intended effect of the separate deduction of FAPLs and FACLs is that taxpayers should no longer be able to reduce FAPI earnings that are on income account with FAPI losses that are on capital account.

ITR
5903.1(1) to (4)

New subsections 5903.1(1) to (4) of the Regulations provide the rules for determining and claiming FACLs for the purposes of new variable F.1 of the FAPI definition in subsection 95(1) of the Act. These rules are essentially equivalent to the FAPL rules in subsections 5903(1) to (4) of the Regulations. The only notable distinction is that the FACL definition is more concise than the FAPL definition. FACLs capture only the excess of current year capital losses over the amount claimed under variable E of the FAPI definition. (FAPLs capture all other amounts that are eligible for carryforward in the determination of FAPI.)

As discussed above under subsection 5903(5), the corporate continuity rules also apply in the FACL context. Furthermore, “relevant person or partnership”, as used in section 5903.1, is defined in subsection 5903(6). This is also discussed above.

This new section applies to foreign affiliate taxation years that end after Announcement Date.

Example 1

Assumptions

1. *Canco, a corporation resident in Canada, owns 100% of the shares of FA, a non-resident corporation.*

2. *FA carries on an investment business, as defined in subsection 95(1).*

3. *FA has the following amounts of income and loss for its 2012 taxation year:*

    a. *$1,000 of property income (under FAPI variable A);*

    b. *$2,000 of taxable capital gains (under FAPI variable B);*

    c. *$300 of property losses (under FAPI variable D);*

    d. *$2,500 of allowable capital losses (under FAPI variable E, pgh. (a));*

    e. *$2,000 of FAPL carryforwards.*

Analysis

FA's FAPI in respect of Canco for 2012 will be based on the following relevant variables from the FAPI definition in subsection 95(1):

$$(A + B) - (D + E + F)$$

In this example, only variables E and F require determination, the others are as indicated above.

The variable E amount is limited to $2,000, being the taxable capital gains included in B.

Canco could claim a variable F amount of up to $2,000, but in this example only $700 is required to bring FAPI to zero, i.e. A + B – D – E = $1,000 + $2,000 – $300 – $2,000 = $700. Thus, it would be expected that Canco would claim $700 under variable F such that FA would have a remaining FAPL balance of $1,300.

In addition, FA will have, pursuant to new subsection 5903.1(3), a FACL for 2012 based on the excess of the amount under paragraph (a) of variable E ($2,500) over the amount claimed under E ($2,000). This $500 FACL can be carried back 3 years and forward for 20 years, pursuant to new subsection 5903.1(1).

Example 2

Assumptions

1. *Canco, a corporation resident in Canada, owns 100% of the shares of FA, a non-resident corporation.*
2. *FA carries on an investment business, as defined in subsection 95(1).*
3. *FA has the following amounts of income and loss for its 2012 taxation year:*
    a. *$1,000 of property income (under FAPI variable A);*
    b. *$2,000 of taxable capital gains (under FAPI variable B);*
    c. *$2,500 of property losses (under FAPI variable D);*
    d. *$2,200 of FACL carryforwards.*

Analysis

FA's FAPI in respect of Canco for 2012 will be based on the following relevant variables from the FAPI definition in subsection 95(1):

$$(A + B) - (D + F.1)$$

In this example, only variable F.1 requires determination, the others are as indicated above.

Canco can get a deduction under variable F.1 of up to \$2,000 because \$2,000 of taxable capital gains are included under variable B. If Canco makes a full \$2,000 claim under variable F.1, the FAPI formula would produce a negative amount of \$1,500 (\$1,000 + \$2,000 – \$2,500 – \$2,000). This negative amount would simply mean that no FAPI inclusion would arise, as section 257 of the Act would force the amount to nil. Thus, Canco only needs to make a \$500 claim under variable F.1 to wipe out FA1's FAPI. However, it is important to note that a \$2,000 claim under variable F.1 (which would reduce the FACL balance to \$200) would not waste the extra \$1,500 as that excess amount would be picked up as a FAPL under amended paragraph 5903(3)(a), because of the reduction of the variable L amount to zero. In such a case, paragraph 5903(3)(a) would compute a FAPL for 2012 of J – K – L, in this case derived by D – A – (B – F.1), which is \$2,500 – \$1,000 – (\$2,000 – \$2,000) = \$1,500.

Thus, Canco has a choice between FAPL carryforwards and FACL carryforwards.

Clause 28

Participating percentage

ITR
5904

Section 5904 of the Regulations determines "participating percentage" for the purposes of subparagraph (*b*)(ii) of the definition "participating percentage" in subsection 95(1) of the Act. Essentially, this is determined based on the concept of "equity percentage" in subsection 95(4) of the Act, with a few modifications, as set out in paragraphs 5904(1)(*a*) to (*c*). Subsection 5904(2) provides the meaning of "distribution entitlement" for the purposes of paragraphs 5904(1)(*b*) and (*c*), and subsection 5904(3) provides interpretive rules for the purposes of subsection 5904(2).

Paragraph 5904(1)(*c*) currently provides that where "distribution entitlement" is nil, "direct equity percentage" is derived directly from the concept of "direct equity percentage" in subsection 95(4), i.e. without modification.

This "nil distribution entitlement" rule is being replaced with a rule that measures net surplus (for the purposes of the distribution entitlement definition in subsection 5904(2)) based on the greater of the retained earnings of the relevant affiliate and 25% of its total assets. (A similar modification is being made in subsection 5905(11) in the context of the "surplus entitlement percentage" rules.)

Paragraph 5904(3)(*b*) provides an interpretive rule to deal with circular shareholdings. This rule is similar to the rule in subparagraph 5902(2)(*a*)(i) that is discussed above, and it is being similarly amended. For more details, refer to the comments under that subparagraph.

These amendments apply to foreign affiliate taxation years that begin after Announcement Date.

Clause 29

Reorganizations

ITR
5905

Section 5905 of the Regulations provides special rules for the purposes of determining surpluses and deficits and underlying foreign tax balances of a foreign affiliate in the context of certain share transactions and corporate reorganizations.

ITR
5905(1) to (5.1)

Subsections 5905(1) to (5.1) provide rules for resetting or establishing, depending on the provision, the amount of the exempt surplus or deficit, taxable surplus or deficit and underlying foreign tax of a foreign affiliate (and, in general, of each other foreign affiliate in which the affiliate has an equity percentage) in cases where:

- the surplus entitlement percentage of the corporation in respect of the particular affiliate increases or decreases because of certain acquisitions or dispositions of shares of the particular affiliate (subsection 5905(1));

- the affiliate has been formed as a result of a foreign merger (subsection 5905(3));

- shares of the affiliate are transferred between non-arm’s length Canadian corporations, including transfers occurring as a result of certain windings-up (subsection 5905(5)); or

- foreign affiliate shares become property of a merged entity as a result of an amalgamation governed by subsection 87(1) of the Act (subsection 5905(5.1)).

Subsections 5905(1), (3), (5) and (5.1) are amended, consequential to the introduction of the “hybrid surplus” concept, so that they also reset or establish, as the case may be, balances of “hybrid surplus”, “hybrid deficit” and “hybrid underlying tax”.

These amendments apply to relevant events that occur after Announcement Date.

ITR
5905(5.5) to (5.7)

Current subsections 5905(5.5) and (5.6) of the Regulations provide the meaning of the term “tax-free surplus balance” (“TFSB”) for the purposes of subsections 5905(5.2), (5.4), (7.2) and (7.3) of the Regulations. As discussed above, this definition is also relevant for amended paragraph 55(5)(*d*) of the Act except that subsection 5905(5.6) does not apply for that purpose.

The TFSB of a foreign affiliate is a measure of the “good” surplus inherent in the affiliate. “Good” surplus is, generally, the aggregate of exempt surplus and the grossed-up amount of underlying foreign tax (i.e., taxes paid in respect of taxable surplus).

These rules are being amended to incorporate references to the relevant “hybrid surplus” concepts through, among other things, the addition of new paragraph 5905(5.5)(*a.1*) and new subsection 5905(5.7). (The latter subsection, as well as amendments to subparagraph 5905(5.5)(*b*)(ii), deal with deficit offsets.) Although hybrid surplus has many similarities to taxable surplus, there is no ability to make a disproportionate hybrid underlying tax (“HUT”) election. As such, it is not appropriate to consider the grossed-up value of all HUT to represent tax-free surplus and, therefore, hybrid surplus balances are only included in the TFSB definition if they would be 100% deductible.

The amendments to subsections 5905(5.5) and (5.6) and the addition of subsection 5905(5.7) apply after Announcement Date.

Example

Assumptions

1. *Canco, a corporation resident in Canada, owns 100% of the shares of FA, a non-resident corporation.*

2. *FA does not have an interest in any other foreign affiliate of Canco.*

3. *Canco undergoes an acquisition of control on January 1, 2012.*

4. *On December 31st, 2011, FA’s surplus and deficit balances in respect of Canco are as follows:*

	Case A	*Case B*
Exempt surplus	--	*$200*
Hybrid surplus	*$900*	*850*
Hybrid underlying tax	*100*	*150*

Taxable deficit	--	*(300)*

5. *Canco's tax rate is 25%.*

Analysis

Under subsection 5905(5.2), Canco could, as a result of the acquisition of control, suffer a reduction of FA's surplus balances depending on the quantum of FA's "tax-free surplus balance" ("TFSB") and the adjusted cost base and fair market value of Canco's shares of FA. This example deals only with the computation of TFSB.

In Case A, Canco's "relevant tax factor", as defined in subsection 95(1), is 1/0.25 = 4. Thus, the amount determined by the formula in paragraph 5905(5.5)(a.1) is $800 (($100 x 3.5) + ($900 x 0.5)). Since this amount is less than FA's hybrid surplus balance, no portion of that $900 hybrid surplus balance is included in TFSB. This is consistent with the fact that FA's 10% tax rate on its hybrid surplus is lower than Canco's effective tax rate of 12.5% in respect of capital gains.

In Case B, the amount determined by the formula in paragraph 5905(5.5)(a.1) is $950 (($150 x 3.5) + ($850 x 0.5)). Since this amount is greater than FA's $850 hybrid surplus balance, the amount of hybrid surplus to be included in TFSB under paragraph 5905(5.5)(a.1) is FA's hybrid surplus balance of $850 less the amount determined under subsection 5905(5.7). In Case B, the amount determined under subsection 5905(5.7) is $100, being the amount by which FA's taxable deficit exceeds FA's exempt surplus. FA's TFSB is thus $750. The inclusion of FA's hybrid surplus in this case is consistent with the fact that FA's 15% tax rate on its hybrid surplus is greater than Canco's effective tax rate of 12.5% in respect of capital gains.

ITR
5905(7)

Subsection 5905(7) of the Regulations applies where a foreign affiliate is liquidated into another foreign affiliate and paragraph 95(2)(*e.1*) of the Act is applicable. Essentially, subsection 5905(7) provides for the transfer of the liquidating affiliate's positive surplus balances into the shareholders of the liquidating affiliate.

As noted above, paragraph 95(2)(*e.1*) of the Act is being repealed and in its place paragraph 95(2)(*e*) of the Act is being amended to provide rules in respect of a liquidation and dissolution that is a "designated liquidation and dissolution", as newly defined in subsection 95(1) of the Act. Accordingly, subsection 5905(7) is amended to reflect the restructuring of those paragraphs.

Subsection 5905(7) is also being amended to reflect the introduction of the "hybrid surplus" concept.

These amendments apply in respect of liquidations and dissolutions that begin after Announcement Date. However, they will have earlier application if the taxpayer elects retroactive treatment of the amendments to paragraphs 95(2)(*e*) and (*e.1*). In such cases, a transitional reading of subsection 5905(7) is provided in order to remove the references to the hybrid surplus concept.

ITR
5905(11)

Subsection 5905(11) of the Regulations provides interpretive rules for the purposes of the determination of "surplus entitlement" in subsection 5905(10). The "surplus entitlement" determined by subsection 5905(10) is relevant in computing the corporation's "surplus entitlement percentage", as defined in subsection 5905(13) of the Regulations, in respect of a foreign affiliate.

Paragraph 5905(11)(*a*) provides an interpretive rule to deal with circular shareholdings. This rule is similar to the rules in subparagraph 5902(2)(*a*)(i) and paragraph 5904(3)(*b*) that are discussed above, and it is being similarly amended. For more details, refer to the comments under subparagraph 5902(2)(*a*)(i).

Subsection 5905(11) is also amended by adding paragraph (*c*), which sets out a rule to address situations where a foreign affiliate's net surplus is nil. This new rule measures net surplus based on the greater of the retained earnings of the relevant affiliate and 25% of its total assets. New paragraph 5905(11)(*c*) replaces the "postamble" of current paragraph 5905(13)(*b*), which is being repealed, as noted below.

These amendments apply after Announcement Date.

ITR
5905(12)

Subsection 5905(12) of the Regulations is also an interpretive rule for the purposes of the determination of "surplus entitlement" in subsection 5905(10) and, consequently, "surplus entitlement percentage" in subsection 5905(13). It provides for a pro-ration of exempt and taxable earnings (or loss) of a foreign affiliate based on the number of days in a taxation year that is deemed to have ended under a provision of section 5905 over the number of days in the normal taxation year of the foreign affiliate.

Subsection 5905(12) is being repealed – it is no longer necessary because there are no longer any provisions in section 5905 that deem a short year for the purposes of determining "surplus entitlement percentage".

The repeal of subsection 5905(12) applies after December 18, 2009.

ITR

5905(13) and (14)

Subsection 5905(13) of the Regulations provides the meaning of the expression “surplus entitlement percentage” (“SEP”) for the purposes of Part LIX of the Regulations and subdivision i of Division B of Part I of the Act (by virtue of the definition “surplus entitlement percentage” in subsection 95(1)).

Paragraph 5905(13)(*a*) applies in the case where each corporation that is relevant to the determination of a corporation’s “equity percentage” in a particular foreign affiliate has only one class of issued shares. In that case, the corporation’s SEP in respect of the particular affiliate is equal to that “equity percentage”. For the purposes of that paragraph, “equity percentage” has the meaning assigned by subsection 95(4) of the Act but is modified slightly by the “postamble” of subsection 5905(13).

Paragraph 5905(13)(*b*) provides a catch-all rule for situations where paragraph (*a*) does not apply. Paragraph (*b*) requires a more complex determination of SEP that is based on “surplus entitlement”, the meaning of which is given by subsection 5905(10), as discussed above.

A number of amendments are being made to subsection 5905(13) and a new subsection 5905(14) is being added.

First, an additional condition is being added to paragraph 5905(13)(*a*). This condition deals with circular shareholdings and is similar to the change to “participating percentage” that is discussed above in the context of subsection 95(1). Essentially, where there are circular shareholdings, SEP will now have to be determined under the more complex rules of paragraph (*b*), even where the relevant foreign affiliates only have one class of shares outstanding.

Second, the “postamble” of paragraph 5905(13)(*b*) is being repealed and replaced with new paragraph 5905(11)(*c*), as discussed above.

Third, the “postamble” of subsection 5905(13) is being moved, without any substantive modification (other than the addition of a reference to subsection 5905(10)), to new subsection 5905(14).

The amendments to subsection 5905(13) and the addition of subsection 5905(14) apply after Announcement Date.

Clause 30

Interpretation

ITR
5907

Section 5907 of the Regulations provides definitions and rules of interpretation for the purposes of Part LIX of the Regulations and also prescribes certain rules for particular foreign affiliate provisions of the Act.

ITR
5907(1)

Subsection 5907(1) of the Regulations provides definitions for the purposes of Part LIX of the Regulations.

A number of definitions are being amended and some new definitions are being added.

Amended definitions

"earnings"

Paragraph (*b*) of the definition "earnings" in subsection 5907(1) of the Regulations incorporates deemed active business income (pursuant to paragraph 95(2)(*a*) of the Act) into the earnings of a foreign affiliate. Such earnings enter into the computation of either exempt or taxable earnings and then exempt or taxable surplus or deficit of a foreign affiliate.

Paragraph (*b*) is being amended to ensure that the "forced deductions" rule in new subsection 5907(2.03) is taken into account in computing those earnings. For more details, refer to the commentary below for new subsection 5907(2.03).

This amendment applies to foreign affiliate taxation years that end after Announcement Date.

"exempt earnings"

The definition "exempt earnings" is relevant for the purposes of computing the exempt surplus and exempt deficit of a foreign affiliate.

This definition is being amended in a number of ways.

First, the "preamble" is being amended to exclude any amounts that would otherwise be included in "exempt earnings" but are instead re-classified as "taxable earnings" by virtue of the new anti-avoidance rule in subsection 5907(2.02), as discussed below.

Second, paragraph (*a*) of "exempt earnings", which deals with capital gains, is being amended to exclude any gains that are included in computing the affiliate's "hybrid surplus" or "hybrid deficit".

Third, subparagraph (*a*)(ii) is being amended to remove the reference to subparagraph (*d*)(iii) of the definition “net earnings” in subsection 5907(1), as a consequence of the repeal of paragraph (*d*) of that definition.

The first and second amendments apply to foreign affiliate taxation years that end after Announcement Date. However, in light of the two-stage transitioning into the “hybrid surplus” regime, as discussed below, the third amendment only applies for taxation years that begin after 2012.

“exempt loss”

The definition “exempt loss” is relevant for the purposes of computing the exempt surplus and exempt deficit of a foreign affiliate.

The amendments to “exempt loss” are similar to the amendments to “exempt earnings”, including the coming-into-force provisions. For details, refer to the commentary under “exempt earnings”, directly above.

“exempt surplus”

The definition “exempt surplus” is primarily relevant for the purposes of determining the deductibility of dividends received from a foreign affiliate, pursuant to subsections 5900(1) of the Regulations and subsection 113(1) of the Act.

Subparagraph (vii) of the description of A in the definition “exempt surplus” includes in the computation of a foreign affiliate’s exempt surplus all amounts added to the affiliate’s exempt surplus under paragraph 5907(7.1)(*d*). Consequential to the repeal of subsection 5907(7.1), subparagraph (vii) is being amended to indicate that the reference to paragraph 5907(7.1)(*d*) is relevant only for dividends paid on or before Announcement Date.

The definition “exempt surplus” is also being amended in order to modernize its structure and to make it correspond with the structure of the new definition “hybrid surplus” in subsection 5907(1).

These amendments apply after Announcement Date.

“loss”

Paragraph (*b*) of the definition “loss” in subsection 5907(1) of the Regulations incorporates deemed active business losses (pursuant to paragraph 95(2)(*a*) of the Act) into the loss of a foreign affiliate. Such losses enter into the computation of either exempt or taxable loss and then exempt or taxable surplus or deficit of a foreign affiliate.

The amendments to “loss” are similar to the amendments to “earnings”, including the coming-into-force provisions. For details, refer to the above notes under “earnings”.

“net earnings” and “net loss”

The definitions “net earnings” and “net loss” are relevant for the purposes of computing the surpluses and deficits of a foreign affiliate.

Paragraph (*b*) of the definition “net earnings” ensures that the FAPI of a foreign affiliate is included in computing the affiliate’s “taxable earnings” and, ultimately, “taxable surplus” or “taxable deficit”.

Paragraph (*b*) is being amended as a consequence of the addition of new variable F.1 to the FAPI definition in subsection 95(1) of the Act and the amendments to variable E of that definition. These amendments are part of the initiative to “stream” capital losses in a FAPI context. For more details, refer to the commentary above for new section 5903.1 of the Regulations.

The amendment to paragraph (*b*) applies to foreign affiliate taxation years that end after Announcement Date.

Subparagraph (*d*)(i) of the definition “net earnings” ensures that taxable capital gains (net of income or profits tax) from the disposition of shares of the capital stock of another foreign affiliate that are excluded property of a particular affiliate are included in computing the particular affiliate’s “taxable earnings” and, ultimately, “taxable surplus” or “taxable deficit”. Subparagraph (*d*)(ii) provides similar results in respect of dispositions of partnership interests.

Consequential to the introduction of the concept of “hybrid surplus”, subparagraphs (*d*)(i) and (ii) of the definition “net earnings” are being amended so that “net earnings” does not include gains that are subject to the hybrid surplus regime.

In addition, subparagraph (*d*)(i) is being amended to include, in its carve-out provision, a reference to amended paragraph 95(2)(*d.1*) of the Act as that amended paragraph now contemplates the possibility of a gain arising under a so-called “relevant cost base” election, as defined in subsection 95(4).

These amendments to paragraph (*d*) apply to foreign affiliate taxation years that end after Announcement Date. However, if a taxpayer elects retroactive application of amended paragraph 95(2)(*d.1*) (i.e. for mergers or combinations that occur after December 20, 2002), the additional reference to that paragraph applies on the same basis.

Paragraph (*d*) of the definition “net earnings” is repealed altogether for foreign affiliate taxation years that begin after 2012. This reflects the two-stage transition into the hybrid surplus regime, as discussed below.

“Net loss” is being amended on a similar basis to the amendments to paragraphs (*b*) and (*d*) of “net earnings” (except that a reference to variable H in the FAPI definition is also being added), including the repeal of its paragraph (*d*). The application dates are also the same.

“net surplus”

The definition “net surplus” in subsection 5907(1) of the Regulations is relevant for various provisions of the Regulations which require measurement of a foreign affiliate’s total surplus balances. “Net surplus” is currently measured as the aggregate of an affiliate’s exempt and taxable surplus, where there is no exempt or taxable deficit, and by way of netting where one balance is positive (surplus) and the other is negative (deficit).

The definition “net surplus” is being amended as a consequence of the introduction of the “hybrid surplus” concept.

This amendment applies after Announcement Date.

“taxable earnings”

The definition “taxable earnings” is relevant for the purposes of computing the taxable surplus and taxable deficit of a foreign affiliate.

Paragraph (*b*) of the definition “taxable earnings” is being amended to add a new subparagraph (iv.1) which captures amounts that are re-classified from “exempt earnings” to “taxable earnings” under the anti-avoidance rule in new subsection 5907(2.02) of the Regulations, as discussed below.

This amendment applies to foreign affiliate taxation years that end after Announcement Date.

“taxable surplus”

The definition “taxable surplus” is primarily relevant for the purposes of determining the deductibility of dividends received from a foreign affiliate, pursuant to subsection 5900(1) of the Regulations and subsection 113(1) of the Act.

This definition is being amended in three ways.

First, subparagraph (v) of the description of A in the definition “taxable surplus”, which includes in an affiliate’s taxable surplus all amounts added under paragraph 5907(7.1)(*e*) of the Regulations, is being amended as a consequence of the repeal of subsection 5907(7.1) to indicate that the reference to paragraph 5907(7.1)(*e*) is relevant only for dividends paid on or before Announcement Date.

Second, subparagraph (iv) of the description of B in the definition “taxable surplus”, which deducts in the computation of an affiliate’s taxable surplus the portion of any whole dividend paid by the affiliate that is deemed by paragraph 5901(1)(*b*) to have been paid out of the affiliate’s taxable surplus, is being amended to contemplate the possibility of an election under subsection 5901(1.1) of the Regulations. Such an election has the effect of re-ordering taxable and hybrid surplus in respect of the payment of a particular “whole dividend”. Where such an election is made, the taxable surplus amounts are governed by paragraph 5901(1)(*a.1*) rather than paragraph (*b*).

Third, the definition “taxable surplus” is being amended in order to modernize its structure and to make it correspond with the structure of the new definition “hybrid surplus” in subsection 5907(1).

These amendments apply after Announcement Date.

“underlying foreign tax”

The definition “underlying foreign tax” in subsection 5907(1) of the Regulations is primarily relevant for the purposes of determining the deductibility of dividends received from a foreign affiliate of a corporation, pursuant to subsections 5900(1) of the Regulations and subsection 113(1) of the Act.

Three amendments are being made in this regard.

First, subparagraph (ii) of the description of A of the “underlying foreign tax” definition includes the portion of any income or profits tax paid to the government of a country by a foreign affiliate that can reasonably be regarded as having been paid in respect of taxable earnings. Consequential to the introduction of the anti-avoidance rule in new subsection 5907(2.02) of the Regulations, which reclassifies certain amounts of exempt earnings to taxable earnings, subparagraph (ii) is being amended to include, for greater certainty, the portion of any income or profits tax that relates to amounts included in taxable earnings by virtue of paragraph 5907(2.02)(*a*).

Second, subparagraph (ii) of the description of B of the “underlying foreign tax” definition, which reduces the underlying foreign tax of a foreign affiliate by the amount of the underlying foreign tax applicable to any whole dividend paid by the affiliate that is deemed by paragraph 5901(1)(*b*) to have been paid out of the affiliate’s taxable surplus, is being amended to contemplate the possibility of an election under subsection 5901(1.1) of the Regulations. Such an election has the effect of re-ordering taxable and hybrid surplus in respect of the payment of a particular “whole dividend”. Where such an election is made, the taxable surplus amounts are governed by paragraph 5901(1)(*a.1*) rather than paragraph (*b*). Amended subparagraph (ii) thus makes reference to paragraph 5901(1)(*a.1*), in appropriate circumstances.

Third, the definition “underlying foreign tax” is being amended in order to modernize its structure and to make it correspond with the structure of the new definition “hybrid underlying tax” in subsection 5907(1).

The first amendment applies to foreign affiliate taxation years that end after Announcement Date. The second and third amendments apply after Announcement Date.

New definitions

“designated person or partnership”

The definition “designated person or partnership” is a new definition that is being added to support amended subparagraph 5907(2)(*f*)(ii), new subsection 5907(2.01), amended subsection 5907(5.1) and the transitional readings of the descriptions of A and B in the new definition of “hybrid surplus” in subsection 5907(1). This new definition identifies certain non-arm’s length persons or partnerships in relation to a taxpayer.

This new definition applies after Announcement Date.

“hybrid deficit”

The definition “hybrid deficit” is a new definition that is being added consequential to the introduction of the “hybrid surplus” regime. “Hybrid deficit” is simply the term that applies when “hybrid surplus” is negative. It is similar in structure to the definitions “exempt deficit” and “taxable deficit” in subsection 5907(1).

This new definition applies after Announcement Date.

“hybrid surplus”

The definition “hybrid surplus” is a new definition that is being added to capture capital gains and losses from the disposition of certain shares of a foreign affiliate, certain partnership interests and certain financial instruments relating to such shares and partnership interests.

“Hybrid surplus” replaces the current regime whereby one-half of capital gains realized in respect of dispositions of the above-noted items is included in exempt surplus and one-half is included in taxable surplus. The entire amount of such capital gains will now be included in “hybrid surplus”. Upon repatriation of such amounts to Canadian corporate shareholders, one-half of hybrid surplus amounts will be deductible from taxable income and the other half will be eligible for a deduction based on grossed-up underlying tax. These deductions are provided for in new paragraph 113(1)(*a.1*) of the Act, as discussed above. Essentially, this new regime retains the current principles inherent in the categorization of such gains with one significant difference: both components of those surplus amounts will now be required to be distributed together, i.e. it will no longer be possible to distribute only the exempt portion and defer the distribution of the taxable portion.

The structure and content of the definition "hybrid surplus" is otherwise similar to the definitions "exempt surplus" and "taxable surplus", with three additional distinctions:

- there is no equivalent to "exempt earnings" or "taxable earnings" – the equivalent provisions are incorporated directly into the "hybrid surplus" definition,

- hybrid surplus amounts in respect of capital gains arise at the time of the relevant disposition rather than upon the completion of a foreign affiliate's taxation year, and

- hybrid surplus contains, in subparagraph (iii) of the description of B, a reduction for any capital loss of a foreign affiliate from a disposition of non-excluded property shares of a disposing affiliate that are disposed of in the course of a liquidation and dissolution that is a designated liquidation and dissolution of the disposing affiliate. For more details, see the commentary above for amended paragraph 95(2)(*e*) of the Act.

This new definition applies after Announcement Date for dispositions to a "designated person or partnership", but only after 2012 in respect of dispositions to other persons or partnerships. For that transitional period, section 5907 is to be read as if it contained an additional subsection that specifies the identity of the person or partnership to which certain types of dispositions are made.

"hybrid underlying tax"

The definition "hybrid underlying tax" is a new definition that is being added to subsection 5907(1) of the Regulations in order to account for taxes paid in respect of "hybrid surplus". Its structure and effect are similar to the concept of "underlying foreign tax", which applies in the context of "taxable surplus".

This new definition applies after Announcement Date.

"hybrid underlying tax applicable"

The definition "hybrid underlying tax applicable" ("HUTA") is a new definition that is being added to subsection 5907(1) of the Regulations. Its structure and effect are similar to the concept of "underlying foreign tax applicable", which applies in the context of "taxable surplus", with one significant exception: HUTA does not contain an ability to disproportionately allocate underlying taxes to a particular dividend paid from "hybrid surplus".

This new definition applies after Announcement Date.

ITR
5907(1.01)

Subsection 5907(1.01) of the Regulations provides that, for the purposes of section 113 of the Act, “exempt surplus” and “taxable surplus” have the meanings assigned by subsection 5907(1). Subsection 5907(1.01) is being amended to similarly provide that “hybrid surplus” has the meaning provided by subsection 5907(1).

This amendment applies after Announcement Date.

ITR
5907(1.1)

Subsection 5907(1.1) of the Regulations contains rules for the computation of the surpluses and deficits of a foreign affiliate where the affiliate is a member of a group of foreign affiliates that files a consolidated or combined return in a foreign country, such as the United States, and one of the affiliates in the group is responsible for paying the tax of all members of the group.

Subsection 5907(1.1) is being amended to add corresponding rules for the computation of the hybrid surplus, hybrid deficit and hybrid underlying tax of a foreign affiliate where the affiliate is a member of a consolidated group.

These amendments apply to foreign affiliate taxation years that end after Announcement Date.

ITR
5907(1.2)

Subsection 5907(1.2) of the Regulations contains rules for the computation of the surpluses and deficits of a foreign affiliate where the affiliate is entitled under foreign tax law to deduct losses of another foreign affiliate.

Subsection 5907(1.2) is being amended to add corresponding rules for the computation of the hybrid surplus, hybrid deficit and hybrid underlying tax of a foreign affiliate.

These amendments apply to foreign affiliate taxation years that end after Announcement Date.

ITR
5907(1.3) to (1.6)

Subsection 91(4) of the Act provides for a deduction in the computation of a taxpayer's income in respect of the foreign accrual tax that is attributable to an amount of FAPI that is included in the computation of the taxpayer's income. Subsection 95(1) of the Act defines "foreign accrual tax" to include amounts prescribed to be foreign accrual tax.

In circumstances where the loss of another corporation in a particular group of foreign affiliates is relevant in the computation of the tax liability of the group to a foreign government, paragraphs 5907(1.3)(*a*) and (*b*) of the Regulations provide that an amount will be considered foreign accrual tax if the amount is paid by the particular corporation to the other corporation in the group in respect of the use of a loss of any other corporation in the computation of the group's tax liability to the foreign government. These provisions apply where the loss of the other corporation is an active business loss or a capital loss resulting from the disposition of excluded property as well as where the loss is one that is determined under the current version of paragraph 5903(1)(*a*). (Paragraph 5907(1.3)(*a*) can also apply where there are no group losses and a particular affiliate is simply reimbursing another foreign affiliate for the taxes the particular affiliate would have paid had it not been a member of the group.)

Subsection 5907(1.3) is amended, as a consequence of the introduction of new subsection 5907(1.4), to provide that it is subject to subsection 5907(1.4).

New subsection 5907(1.4) ensures that an amount paid by a particular affiliate to another corporation, as contemplated by subsection 5907(1.3), that is in respect of a loss of another corporation will only be foreign accrual tax to the extent that the amount paid can reasonably be considered to be in respect of a FAPL of a controlled foreign affiliate of a person or partnership that is, at the end of the relevant taxation year, a relevant person or partnership (within the meaning of new subsection 5903(6)) in respect of the taxpayer. This is consistent with the fact that, under subsection 5903(3) of the Regulations, active business losses and capital losses resulting from the disposition of excluded property of a foreign affiliate are not included in the computation of a FAPL.

New subsections 5907(1.5) and (1.6) allow foreign accrual tax that is initially denied under subsection 5907(1.4) to be reinstated in the year in which the loss that caused the denial, and all other losses of group members for that same taxation year, would otherwise have been used against non-FAPI of the consolidated group, provided those losses are used up within 5 years of the year in which the FAPI is realized.

Amended subsection 5907(1.3) and new subsections 5907(1.4) to (1.6) apply to taxation years of a foreign affiliate that begin after November 1999. Note, however, that subsection 5907(1.4) is also being amended for foreign affiliate taxation years that end after Announcement Date, as discussed below.

Example

Assumptions

1. *Canco is a corporation resident in Canada that owns all the shares of a corporation resident in the U.S. (FA1).*

2. *FA1 owns all the shares of two other U.S. resident corporations (FA2 and FA3).*

3. *FA1, FA2 and FA3 form a consolidated group for U.S. income tax purposes.*

4. *FA1 has no income or loss for its 2004 taxation year.*

5. *FA2 has FAPI of $400, and no other income or loss, in its 2004 taxation year.*

6. *FA3 has active business losses of $300, and no other income or loss, in its 2004 taxation year.*

7. *The FA1/FA2/FA3 group pays U.S. tax of $35 for the 2004 taxation year.*

8. *FA2 pays $140 to FA1 for the U.S. tax that FA2 would have paid for its 2004 taxation year had it not been a member of the consolidated group.*

9. *FA1 pays $105 to FA3 as compensation for the use of FA3's 2004 tax loss.*

10. *None of FA1, FA2 or FA3 has any income or loss from any source for their 2005 taxation year.*

11. *In their 2006 taxation years, FA1 and FA2 have no income or loss from any source, and FA3 has only active business income of $200.*

12. *In their 2007 taxation years, FA1 and FA2 have no income or loss from any source, and FA3 has only active business income of $150.*

Analysis

Of the $140 paid by FA2 to FA1 for its 2004 taxation year that is otherwise prescribed under paragraph 5907(1.3)(a) to be foreign accrual tax, $105 can reasonably be considered to be in respect of the $300 loss of FA3, and since this $300 loss is a non-foreign accrual property loss of FA3, subsection 5907(1.4) will reduce the amount otherwise prescribed under subsection 5907(1.3) by $105 – the amount prescribed by subsection 5907(1.3) for 2004 will be $35. In 2006 some of FA3's 2004 loss is used up against active business income, but the $105 is not reinstated because not all losses of the group for the 2004 taxation year have yet been fully deducted against non-FAPI income. In 2007, the $105 will be prescribed under subsection 5907(1.5) to be a foreign accrual tax to the taxpayer because in that year (the "designated taxation year") the $300 active *business loss of FA3 in 2004 would have been fully deducted against FA3's aggregate active business income in 2006 and 2007.*

However, if the group realized an overall loss in 2008 of, say, $180 and assuming that U.S. tax law allows for loss carrybacks, then pursuant to paragraph 5907(1.6)(b) the reinstatement would be deferred until a future year when an additional $130 of non-FAPI income is earned by the group. If this does not occur until 2010, reinstatement will be permanently lost because 2010 is outside of the 5 year window provided for in paragraph 5907(1.6)(c).

ITR
5907(1.4)

Subsection 5907(1.4) of the Regulations ensures that an amount paid by a particular affiliate to another corporation, as contemplated by subsection 5907(1.3), that is in respect of a loss of another corporation will only be foreign accrual tax to the extent that the amount paid can reasonably be considered to be in respect of a FAPL of a controlled foreign affiliate of a person or partnership that is, at the end of the relevant taxation year, a relevant person or partnership (within the meaning of new subsection 5903(6)) in respect of the taxpayer.

Subsection 5907(1.4) is being amended to make appropriate references to the new FACL concept. For more details, refer to the above commentary for new section 5903.1 of the Regulations.

This amendment applies to foreign affiliate taxation years that end after Announcement Date.

ITR
5907(1.7)

New subsection 5907(1.7) of the Regulations denies "deemed foreign accrual tax" otherwise available under subsection 5907(1.3) where the amounts paid are in respect of FACLs of another corporation that would not be deductible by the payer affiliate if those FACLs had been incurred by the payer affiliate. (FACLs are discussed in the commentary to new section 5903.1 above.) This rule is meant to put the payer affiliate in the same position as the loss affiliate in terms of limiting a capital loss claim to the amount of capital gains included under variable B of the FAPI definition in subsection 95(1) of the Act.

This amendment applies to foreign affiliate taxation years that end after Announcement Date.

ITR
5907(2)

Subsection 5907(2) of the Regulations provides a number of rules that adjust amounts otherwise determined under subparagraphs (*a*)(i) and (ii) of the definition "earnings" in subsection 5907(1) of the Regulations.

Paragraph 5907(2)(*f*) provides for additions to "earnings" of certain items of revenue, income or profit that are not otherwise included in "earnings" under the relevant foreign tax law. Subparagraph (ii) provides an exception to this addition in certain circumstances in which a foreign tax rollover rule applies on a disposition to another foreign affiliate or a non-arm's length person.

Paragraph 5907(2)(*j*) is the "flip side" of paragraph 5907(2)(*f*) in that it provides for certain reductions to "earnings". It also contains, in subparagraph (iii), an exception for certain foreign tax rollovers.

Paragraph 5907(2)(*l*) is a companion rule to paragraph 5907(2)(*f*) to prevent the double counting of the same amounts in two foreign affiliates of a taxpayer or of a non-arm's length Canadian group.

Subparagraphs 5907(2)(*f*)(ii) and (*j*)(iii) are being amended to make them subject to new subsection 5907(2.01), which sets out a situation in which the foreign tax rollover exception is to be ignored.

Subparagraphs 5907(2)(*f*)(ii) and (*j*)(iii) and paragraph (*l*) are being amended to change the references to relevant transferees and transferors to a person or partnership that is a "designated person or partnership" (as newly defined in subsection 5907(1)) in respect of the taxpayer.

These amendments apply to dispositions of property that occur after Announcement Date. However, transitional readings of subparagraphs 5907(2)(*f*)(ii) and (*j*)(iii) apply where the taxpayer elects retroactive application of new subsection 5907(2.01).

ITR
5907(2.01)

New subsection 5907(2.01) of the Regulations is being added to override the tax rollover exceptions in subparagraphs 5907(2)(*f*)(ii) and (*j*)(iii), in certain specified circumstances. Essentially these circumstances involve the "packaging" of certain assets that are to be disposed of to an arm's length purchaser by first transferring the assets to a new company and then selling that new company. This new subsection ensures that any unrealized value in the transferred assets will be eligible for surplus recognition provided, among other things, the shares of the new company are sold within 90 days of the asset transfer.

This new rule is intended to apply to transactions that would otherwise be structured as direct asset sales but that are instead, for foreign commercial reasons, structured as share sales. Where such transactions are so structured primarily for Canadian tax reasons, they could be subject to the new anti-avoidance rule in subsection 5907(2.02), as discussed below.

This new subsection applies to dispositions that occur after Announcement Date, but taxpayers may elect to have it apply to dispositions that occur after December 20, 2002.

ITR
5907(2.02)

New subsection 5907(2.02) of the Regulations is an anti-avoidance rule aimed at tax-motivated transactions that are designed to increase a foreign affiliate's exempt earnings. Where this rule applies, amounts that would otherwise be included in "exempt earnings" are reclassified as "taxable earnings".

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

This new rule applies to transactions entered into after Announcement Date.

ITR
5907(2.03)

New subsection 5907(2.03) of the Regulations deals with the computation of a foreign affiliate's "earnings" under subparagraph (*a*)(iii) and paragraph (*b*) of the definition of "earnings", and its "loss" under paragraph (*b*) of the definition "loss", in subsection 5907(1) of the Regulations. Where that subparagraph or one of those paragraphs applies, a foreign affiliate must generally compute its earnings using Canadian tax rules. New subsection 5907(2.03) assumes, in that regard, that the maximum amount of all permissable deductions have been claimed and all elections under the Act and any enabling legislation have been made in order to maximize deductions. This is meant to prevent taxpayers from purposely inflating surplus.

This rule is similar to the one in current subsection 5910(3) which applies in the context of deemed foreign taxes paid in respect of foreign oil and gas levies.

This new subsection applies to foreign affiliate taxation years that end after Announcement Date.

The special rules in current subsection 5910(3) are no longer necessary and are being repealed, effective at the same time as new subsection 5907(2.03) comes into force. Readers are referred to the commentary under subsection 5910(3) for more information.

ITR
5907(2.9)

Subsection 5907(2.9) of the Regulations applies where the fresh start rules in paragraph 95(2)(*k*) of the Act apply to a foreign affiliate in respect of a “foreign business”. Subsection 5907(2.9) adjusts the “earnings” from an active business of the affiliate for the year that precedes the fresh start year so that the surplus accounts of the affiliate are also subject to a form of fresh start.

Subsection 5907(2.9) is being amended as a consequence of the amendments to paragraph 95(2)(*k*) and the addition of new paragraph 95(2)(*k.1*) of the Act. For details of those amendments, refer to the above commentary for those paragraphs.

The following amendments are being made to subsection 5907(2.9):

- First, subsection 5907(2.9) is being amended to reflect the splitting of paragraph 95(2)(*k*) of the Act into paragraphs (*k*) and (*k.1*).

- Second, the amendments to subsection 5907(2.9) modify the manner in which any necessary reductions are made to the affiliate's relevant surplus accounts. Current subsection 5907(2.9) provides for the reductions to surplus to be made by way of reductions to “earnings”. Amended subsection 5907(2.9) provides instead for those amounts to be included in the “loss” (as defined in subsection 5907(1)) of the affiliate.

- Third, consistent with paragraphs 95(2)(*k*) and (*k.1*) of the Act, the amendments to subsection 5907(2.9) ensure that the fresh start rules will apply where the foreign business is carried on by a partnership of which a foreign affiliate is a member. These amendments to subsection 5907(2.9) ensure, in the case of partnerships, that the fresh start rules will work on the basis of fiscal periods of the partnership and that these rules will therefore be relevant in the computation of the affiliate's foreign accrual property income for the affiliate's taxation year that includes the end of a fiscal period to which the fresh start rules apply.

- Fourth, amended subsection 5907(2.9) broadens the scope of the properties for which deemed fair market value dispositions are to be taken into account in adjusting surplus balances and changes the mechanics for computing those adjustments. These adjustments will now occur for all properties, whether they be the types of properties contemplated by the Canadian tax concepts of depreciable, eligible capital, foreign resource or non-capital property, and will be based on the foreign tax “basis” of the property as determined under paragraph (*a*) of the definition “relevant cost base” in amended subsection 95(4) of the Act. Thus, the adjustment is based on the difference between fair market value and the foreign tax basis of each such property. In the context of property for which tax deductions are claimable under foreign tax law in respect of the cost of the property, such basis is intended to represent the undeducted cost of the property for foreign tax purposes. However, in order to prevent the duplication of amounts in respect of capital gains, which are dealt with, along with capital losses, under subsection 5907(5), such gains are backed out. Note that there is no need to similarly deal with capital losses as none should arise by virtue of these deemed dispositions.

- Fifth, amended subsection 5907(2.9) provides, by reference to new subsection 5908(13), rules for allocating the “earnings” and “loss” adjustments to an affiliate that is a member of a partnership. This allocation is based on the affiliate's direct or indirect share of the income or loss of the partnership. (The reference to “indirect” is meant to address tiered partnerships.) For the purpose of this allocation, new subsection 5908(14) of the Regulations provides that, where both the income and the loss of the partnership for the relevant year are nil, the partnership is assumed to have an income of $1 million for that year.

- Sixth, amended subsection 5907(2.9) ensures that the dispositions and reacquisitions of property that are, under paragraph 95(2)(*k.1*) (by reference to paragraph 138(11.91)(*e*) of the Act), deemed to occur are taken into account in the computation of the affiliate's surplus balances.

It should be noted that any exempt earnings that are otherwise created by these rules are subject to the new anti-avoidance rule in subsection 5907(2.02). Thus, the transition of a foreign affiliate’s business from active to passive is intended to be treated as a transaction that is subject to review under the standards imposed by subsection 5907(2.02). Where that subsection applies, exempt earnings otherwise created under subsection 5907(2.9) will be reclassified as taxable earnings. For further details, refer to the above commentary for new subsection 5907(2.02) of the Regulations.

Amended subsection 5907(2.9) applies in respect of foreign affiliate taxation years that begin after December 20, 2002. However, if the taxpayer elects retroactive application of the amendments to paragraphs 95(2)(*j.1*) to (*k.2*) of the Act, discussed above, amended subsection 5907(2.9) applies in respect of taxation years of all foreign affiliates of the taxpayer that begin after 1994.

ITR
5907(5) and (5.01)

Subsection 5907(5) of the Regulations requires the rules of subsection 95(2) of the Act to be used in computing the capital gains and losses of a foreign affiliate for the purposes of section 5907 of the Regulations. It also sets out how to convert those amounts from Canadian currency, if applicable, to the currency referred to in subsection 5907(6), for surplus accounting purposes.

Subsection 5907(5) of the Regulations is being amended to move its currency conversion rule to new subsection 5907(5.01) of the Regulations. This is being done to facilitate the application of the currency conversion rule to subparagraph (iii) of the description of B in the definition “hybrid surplus” in subsection 5907(1). For more details, refer to the above commentary for the amendments to paragraph 95(2)(*e*) of the Act.

New subsection 5907(5.01) is also adding an exception for cases where the currency referred to in subsection 5907(6) is Canadian currency as, in such a case, no conversion is necessary.

Amended subsection 5907(5) and new subsection 5907(5.01) apply after Announcement Date.

ITR
5907(5.1)

Subsection 5907(5.1) of the Regulations suppresses surplus that would otherwise arise on a disposition by a foreign affiliate of certain capital property to another foreign affiliate of the taxpayer, or of a non-arm’s length person, where foreign tax law provides rollover treatment.

Subsection 5907(5.1) is being amended to refer to the new definition of “designated person or partnership” to identify relevant transferees.

This amendment applies for dispositions that occur after Announcement Date.

ITR
5907(7.1)

Subsection 5907(7.1) of the Regulations ensures that the exempt and taxable surplus of a foreign affiliate of a Canadian corporation is maintained at an appropriate amount where the Canadian corporation in receipt of a dividend from the affiliate also receives a tax credit from the government of the country in which the affiliate resides. Without this amendment the surplus balances of the affiliate would be inappropriately reduced upon the receipt of this tax credit. This rule was designed to deal with the so-called “advance corporation tax” (“ACT”) that applied in the U.K.

This subsection is being repealed as of Announcement Date. This provision is no longer relevant as the U.K. ACT was abolished in 1999.

ITR
5907(8)

Subsection 5907(8) of the Regulations is a rule that applies for the purposes of computing the surplus balances of foreign affiliates that are formed on certain mergers. Subsection 5907(8) creates a deemed year end immediately before the merger for each predecessor of the new corporation and a new taxation year at the time of the merger for the new corporation.

Subsection 5907(8) is being amended to modernize and clarify its language as well as to make its language consistent with other provisions in the Regulations that deal with mergers.

This amendment applies in respect of mergers or combinations in respect of a foreign affiliate of a taxpayer that occur after Announcement Date.

ITR
5907(9)

Subsection 5907(9) of the Regulations provides special surplus rules that apply where a foreign affiliate undergoes a taxable liquidation, i.e. one to which paragraph 95(2)(*e.1*) of the Act does not apply. Subsection 5907(9) consists of four general parts: the conditions for its application, a deemed year-end rule, a dispositions rule and an acquisitions rule.

Subsection 5907(9) is being amended in the following ways.

First, the conditions for its application are being amended to ensure it does not apply to any foreign mergers and the reference to 95(2)(*e.1*) of the Act is being removed. The latter change is consequential to the restructuring of paragraphs 95(2)(*e*) and (*e.1*) of the Act, as discussed above.

Second, the deemed year-end rule is amended to clarify the time at which the fair market value of the relevant property is determined and to replace the "all or substantially all of the property" reference with a simpler "90 percent of the fair market value of the property" reference.

Third, the dispositions rule is amended to clarify the time of the dispositions and to make a more direct link to the special rollover provisions of amended subsection 88(3) and amended paragraph 95(2)(*e*) of the Act. Note that clause 5907(9)(*b*)(i)(A)'s special reading in respect of subsection 88(3.3) is discussed in the commentary above in respect of that subsection.

Fourth, the acquisitions rule is moved from paragraph (*c*) to subparagraph (*b*)(ii).

These amendments generally apply to liquidations and dissolutions that begin after December 20, 2002. However, a number of transitional readings of paragraph 5907(9)(*b*) apply to take into account the different comings-into-force of the amendments to subsection 88(3) and paragraph 95(2)(*e*), including elections in respect thereof.

ITR
5907(9.1)

New subsection 5907(9.1) of the Regulations is added to ensure that the "earnings" of a foreign affiliate that derive from dispositions of property to which the foreign merger provisions in amended paragraph 95(2)(*d.1*) apply, or have previously applied, take into account the rollover rules in that paragraph.

This new subsection applies to mergers or combinations that occur after Announcement Date. However, if a taxpayer elects retroactive application of the amendments to paragraph 95(2)(*d.1*) of the Act, this new subsection applies to mergers or combinations that occur after December 20, 2002.

ITR
5907(13)

Subsection 5907(13) of the Regulations prescribes the amount to be added to the foreign accrual property income ("FAPI") of a foreign affiliate that immigrates to Canada for the purposes of paragraph 128.1(1)(*d*) of the Act. Essentially this rule forces the recognition of the affiliate's taxable surplus immediately before the immigration.

The FAPI inclusion is generally measured as the excess of the affiliate's taxable surplus balance over the grossed-up amount of its underlying foreign tax ("UFT"). However, any taxable surplus and UFT relating to FAPI of the affiliate is backed out from the inclusion formula.

One of the additions to UFT in the inclusion formula (in the description of A in paragraph 5907(13)(*b*)) is a notional amount representing the foreign tax that would have been paid if the dispositions deemed under paragraph 128.1(1)(*b*) of the Act had been actual dispositions (less any amounts that have already been included in UFT).

A number of amendments are being made to subsection 5907(13).

First, it is being restructured in order to make it more user-friendly. New variable X now contains all of the rules that are in current paragraphs (*a*) to (*c*).

Second, as a consequence of the introduction of the "hybrid surplus" concept, analogous rules are being added to account for "hybrid surplus" and "hybrid underlying tax". These rules are found in new variable Y.

Third, to correct an error in the current law, taxable surplus (and hybrid surplus) is now to be reduced by the UFT addition for notional taxes paid in respect of deemed dispositions, as noted above. This is dealt with in new variables C and D (and Q and R for hybrid surplus).

Fourth, the possibility of losses and notional tax refunds in respect of deemed dispositions is now being contemplated by new variables E, F, S and T.

Although these amendments are stated to apply after 1992 (subject to whether the taxpayer elected under a 1994 enactment), the effect of the transitional reading of these amendments is that the amendments in respect of hybrid surplus and those dealing with losses from deemed dispositions apply only after Announcement Date.

ITR
5907(14)

In some instances, the gains that an immigrating foreign affiliate would realize if it had actually disposed of its property may, as a matter of foreign domestic tax law, be taxable but as a result of an income tax convention either the gain may be exempt or the tax may be refundable. New subsection 5907(14) ensures that in such a case variables C and Q (and, consequentially, variables M and U.2) in new subsection 5907(13) do not recognize the treaty exempt portion of any such notional tax.

New subsection 5907(14) applies after 1992 (subject to whether the taxpayer elected under a 1994 enactment), but the references to “hybrid surplus” and related concepts apply only after Announcement Date.

ITR
5907(15)

New subsection 5907(15) is simply the “flip-side” of subsection 5907(14) in that it deals with losses.

This new subsection applies after Announcement Date.

Clause 31

Partnerships

ITR
5908(10)

Subsection 5908(10) of the Regulations prescribes the adjusted cost base (“ACB”) of a partnership interest to a foreign affiliate for the purposes of paragraph 95(2)(*j*) of the Act.

Subsection 5908(10) is amended consequential to the introduction of the “hybrid surplus” concept to allow for ACB adjustments for capital gains and losses realized by a partnership that are included in “hybrid surplus” and “hybrid deficit” of a foreign affiliate.

These amendments apply after Announcement Date.

ITR
5908(13) and (14)

New subsections 5908(13) and (14) of the Regulations provide rules to allocate partnership income for the purposes of the adjustments to “earnings” and “loss” of a foreign affiliate under subsection 5907(2.9). For details, refer to the commentary for amended subsection 5907(2.9) of the Regulations.

These amendments apply on the same basis as the amendments to subsection 5907(2.9), as discussed above.

Clause 32

Foreign oil and gas businesses

ITR
5910(1) and (3)

Subsection 5910(3) provides a so-called “forced deductions” rule for the computation (under subparagraph (*a*)(iii) of the definition of “earnings” in subsection 5907(1) of the Regulations) of a foreign affiliate’s earnings for the purposes of the notional tax amount that is relevant in the determination of deemed income or profits taxes in respect of certain foreign oil and gas businesses.

Section 5910 is being amended consequential to the introduction of new subsection 5907(2.03) which provides a similar “forced deductions” rule for all purposes of the determination of the earnings of a foreign affiliate under subparagraph (*a*)(iii) and paragraph (*b*) of that definition of “earnings” and the determination of its loss under paragraph (*b*) of the definition “loss” in subsection 5907(1). The special rules in current subsection 5910(3) are no longer necessary and are being repealed, effective at the same time as new subsection 5907(2.03) comes into force. Consequentially, the description of B in paragraph 5910(1)(*a*) of the Regulations is being amended to refer directly to the “earnings” definition in subsection 5907(1).

The amendment to paragraph 5910(1)(*a*) and the repeal of subsection 5910(3) apply to foreign affiliate taxation years that end after Announcement Date.

Clause 33

Elections

ITR

5911

New section 5911 of the Regulations prescribes the manner in which various elections are to be made. Subsections 5911(1) and (2) deal with elections in respect of amended subsection 88(3) of the Act and subsection 5911(3) deals with elections in respect of the amended definition of “relevant cost base” in subsection 95(4) of the Act.

New subsections 5911(1) and (2) apply to foreign affiliate liquidations and dissolutions that begin after February 27, 2004. New subsection 5911(3) applies whenever the amended definition of “relevant cost base” applies (see notes above for details). However, there are transitional provisions for all the elections contemplated by new section 5911 that effectively ensure that taxpayers will have a minimum of 120 days after Royal Assent in order to file any such election.

Clause 34

Assessments

Clause 34 of these amendments provides for the automatic override of the normal limitation periods for assessments in subsections 152(4) to (5) of the Act as they would otherwise apply to a taxpayer for the purposes of clauses 1 to 33 of this package of amendments.