Foreign Affiliate Liquidation and Merger Rollovers: Where Are We Now and Where Should We Be?

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P R É C I S
Les règles sur les sociétés étrangères affiliées de la Loi de l'impôt sur le revenu comprennent un certain nombre de dispositions sur les roulements sous forme d'échange d'actions qui permettent aux contribuables canadiens de réorganiser leurs groupes de sociétés étrangères affiliées sans donner lieu à un revenu étranger accumulé, tiré de biens (REATB). Mentionnons le paragraphe 88(3) qui régit la liquidation d'une société étrangère affiliée de niveau supérieur, les alinéas 95(2)e) et e.1) qui régissent la liquidation d'une société étrangère de niveau inférieur et les alinéas 95(2)d) et d.1) qui régissent la fusion de sociétés étrangères affiliées. Généralement, ces règles prévoient un roulement pour toutes les dispositions d'actions de société étrangère affiliée, même si elles ont le statut de bien exclu.

Les propositions législatives du 27 février 2004 contiennent des changements exhaustifs aux règles sur les sociétés étrangères affiliées, incluant des changements qui auraient pour effet d'éliminer les roulements en cas de liquidation et de fusion de société étrangères affiliées pour les dispositions d'actions de société étrangère affiliée qui ne sont pas des biens exclus. Le ministère des Finances a par la suite indiqué que d'autres modifications à ces propositions étaient envisagées. Comme on en est à repenser les règles sur la réorganisation des sociétés étrangères affiliées, l'auteur en profite pour réexaminer l'objet de ces dispositions d'un point de vue de politique fiscale et suggère un cadre à cette fin.

L'auteur place les règles sur la réorganisation des sociétés étrangères affiliées en contexte. Il passe en revue les objectifs politiques des règles sur le REATB comme dispositions anti-évitement et se penche sur le rôle des roulements sous forme d'échange d'actions dans la cadre du régime du REATB. Il analyse les roulements actuels prévus dans le cadre de la liquidation et de la fusion des sociétés étrangères affiliées et les compare aux propositions. Il élabore ensuite un cadre de politique fiscale pour justifier un allégement général continu du REATB en cas de réorganisation sous la forme d'échange d'actions de sociétés étrangères affiliées. Ce cadre est principalement fondé sur le principe de réalisation — les opérations d'échange d'actions ne devraient pas donner lieu à un impôt à payer au titre du REATB, même si les actions ont le statut de bien exclu. L'auteur conclut en recommandant une approche

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destinée à modifier les règles sur la liquidation et la fusion des sociétés étrangères affiliées de façon à assurer la cohérence du principe de réalisation et à rendre les règles sur les roulements sous forme d’échange d’actions de sociétés étrangères affiliées conformes aux règles sur les roulements sous forme d’échange d’actions de sociétés canadiennes.

**ABSTRACT**

The Canadian foreign affiliate rules in the Income Tax Act include a number of share exchange rollovers that permit Canadian taxpayers to reorganize their foreign affiliate groups without triggering foreign accrual property income (FAPI). These include subsection 88(3), which governs liquidations of top-tier foreign affiliates; paragraphs 95(2)(e) and (e.1), which govern liquidations of lower-tier foreign affiliates; and paragraphs 95(2)(d) and (d.1), which govern mergers of foreign affiliates. Generally, these rules provide rollover treatment for all dispositions of foreign affiliate shares, regardless of their excluded-property status.

The February 27, 2004 draft legislation contains extensive proposed changes to the foreign affiliate rules, including changes that would eliminate the foreign affiliate liquidation and merger rollovers for dispositions of non-excluded-property foreign affiliate shares. Subsequent comments from the Department of Finance indicate that further modifications to these proposals are being considered. With a rethinking of the foreign affiliate reorganization rules in progress, the author takes the opportunity to re-examine the purpose of these provisions from a tax policy perspective and to suggest a framework for their redesign.

The author places the proposed foreign affiliate reorganization rules in context. He reviews the policy objectives of the FAPI rules as anti-avoidance provisions and the role of the foreign affiliate share exchange rollovers within the FAPI system. The current foreign affiliate liquidation and merger rollovers are analyzed and compared with the proposed versions. The author then sets out a tax policy framework that supports continued broad rollover relief from FAPI for foreign affiliate share exchange reorganizations. This framework is based principally on the realization principle—share exchange transactions should not give rise to a tax liability in respect of FAPI, regardless of the excluded-property status of the exchanged foreign affiliate shares. The author concludes with a recommended approach to amend the foreign affiliate liquidation and merger rules, so as to maintain consistency with the realization principle and bring the foreign affiliate share exchange rollover rules into conformity with the domestic share exchange rollover rules.

**KEYWORDS:** FOREIGN AFFILIATES ■ FAPI ■ ROLLOVERS ■ TAX POLICY ■ DISSOLUTION ■ MERGERS

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COUNT THE PROPOSALS

On February 27, 2004, the Canadian Department of Finance released extensive proposed amendments1 to the Income Tax Act,2 including changes to the foreign affiliate rules in the Act and the Income Tax Regulations. In large part, the foreign

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2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act or the regulations thereunder.
affiliate proposals are a revised version of the draft legislation originally released on December 20, 2002,1 but with numerous significant changes, including proposals that would dramatically curtail the foreign accrual property income (FAPI) rollovers available for common foreign affiliate reorganizations. A number of possible modifications to the more controversial aspects of the February 27, 2004 foreign affiliate proposals have since been publicly mooted by Finance officials.4 As at the date of writing, however, no specific changes have been publicly released in the form of draft legislation, and it is not clear at this time what revisions will ultimately be made. In its February 23, 2005 federal budget, the Department of Finance commented with respect to the February 27, 2004 proposed amendments that “[t]he Government intends to introduce legislation to implement these proposals at a suitable time, consistent with other legislative priorities.”5 To many observers, this suggests that the revised draft legislation will not be forthcoming any time soon. In the meantime, tax practitioners may reasonably ask themselves the practical question: What rules apply

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4 At the International Tax Seminar of the International Fiscal Association held in Toronto on May 9, 2005 (hereinafter, “the May 9, 2005 IFA seminar”), Wallace Conway of the Department of Finance discussed the February 27, 2004 foreign affiliate proposals and the various modifications that are being considered by Finance. A summary of these modifications under consideration was later circulated to participants at the seminar. To my knowledge, as at the time of writing, that summary represents the most recent thinking of Finance with respect to the proposed amendments. The Department of Finance subsequently released two nearly identical comfort letters dated August 16, 2005 dealing with the application of proposed subsection 88(3) to a distribution of property upon the liquidation or dissolution of a foreign affiliate. These comfort letters, which are discussed in more detail in the section entitled “Modifications Under Consideration by Finance,” describe modifications to proposed subsection 88(3) that are consistent with, and somewhat more detailed than, the May 9, 2005 IFA seminar materials. Mr. Conway had previously discussed the proposed changes at the IFA International Tax Seminar held in Montreal on May 10, 2004, and at the Canadian Tax Foundation’s annual conference held in Toronto on September 26-28, 2004. Some of the possible changes considered at that time are mentioned in Sandra Jack, Brian Mustard, Angelo Nikolakakis, Nick Pantaleo, and Sandra Slalas, “International Taxation: The February 27, 2004 Draft Proposals on Foreign Affiliates,” in Report of Proceedings of the Fifty-Sixth Tax Conference, 2004 Conference Report (Toronto: Canadian Tax Foundation, 2005), 20:1-105. In addition, Len Farber of the Department of Finance, at a meeting of the Montreal Senior Tax Practitioner’s Group on March 10, 2005, discussed possible changes to the proposed foreign affiliate rules under consideration and the ongoing discussions between the Department of Finance and the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants regarding the foreign affiliate proposals. To date, the Joint Committee has not publicly released any commentary on the February 27, 2004 proposals, although it made a submission in respect of the prior version released December 20, 2002. See Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, letter to Len Farber of the Department of Finance Canada, “Proposed Amendments to Foreign Affiliate Rules in December 20, 2002 Draft Legislation,” September 18, 2003.

5 Canada, Department of Finance, 2005 Budget, Budget Plan, February 23, 2005, annex 8, at 411.
to foreign affiliate reorganizations that are implemented today? Although the answer is unfortunately not clear, I will attempt to explain in some detail the existing and proposed rules, and I will suggest what rules ought to apply from a policy perspective.

Among other important changes, the February 27, 2004 proposals would eliminate rollover treatment for non-excluded-property foreign affiliate shares disposed of in the course of certain intragroup reorganizations, including liquidations of top-tier foreign affiliates (subsection 88(3)), liquidations of lower-tier foreign affiliates (paragraphs 95(2)(e) and (e.1)), and foreign mergers (paragraphs 95(2)(d) and (d.1)). If the proposals are enacted, many of these common share exchange reorganizations will be achieved on a tax-deferred basis only if the properties disposed of are foreign affiliate shares that qualify as excluded property. If the foreign affiliate shares are not excluded property (or, as is commonly the case, if the Canadian taxpayer is uncertain whether the shares are excluded property), the Canadian taxpayer may risk triggering a FAPI inclusion in respect of its controlled foreign affiliates, potentially resulting in Canadian tax. The theme of this article is that these proposed limitations will inappropriately restrict the availability of the existing rollover rules applicable to common reorganizations of foreign affiliate groups. I will argue that the proposed rollover restrictions are not desirable from a tax policy perspective and that they will compromise the competitiveness of Canadian-based multinational corporations operating in foreign jurisdictions through controlled foreign affiliates.

Finance is evidently rethinking the original proposals from the February 27, 2004 draft legislation that would limit the FAPI rollovers on foreign affiliate mergers and liquidations to excluded-property shares. According to the comments made at the May 9, 2005 IFA seminar, and as reflected in subsequent comfort letters, Finance is sympathetic to policy concerns such as those discussed in this article and is considering modifications to the original proposals that would, if adopted, go some way toward restoring (and in some respects extending) the existing FAPI rollovers. I will argue in support of these modifications from a tax policy perspective, and I will offer several recommendations for supplemental changes.

THE FOREIGN AFFILIATE REORGANIZATION PROPOSALS IN CONTEXT

The Purpose of the Foreign Affiliate and FAPI Rules

The policy implications of the Finance proposals affecting the FAPI rollovers for liquidations and mergers can be fully appreciated only in the context of the current foreign affiliate and FAPI regime reflected in the Act. The Act subjects Canadian taxpayers (including corporations and individuals) to current taxation of income earned indirectly through a controlled foreign affiliate6 only if that income constitutes

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6 A “controlled foreign affiliate” is defined in subsection 95(1) to mean a foreign affiliate of the taxpayer that is controlled by the taxpayer or, generally, by the taxpayer and not more than four other persons resident in Canada. The definition is proposed to be amended by the February 27, 2004 draft legislation, effectively to overturn the decision of the Federal Court of Appeal in Silicon Graphics v. The Queen, [2002] 3 CTC 527.
Foreign affiliate liquidation and merger rollovers

FAPI, which generally includes property income and certain “passive” business income. Active business income is not imputed to the Canadian shareholder of the controlled foreign affiliate; instead, it adds to the affiliate’s exempt surplus or taxable surplus, depending on whether the business income has a source in a country with which Canada has a tax treaty. Dividends paid to a Canadian corporate shareholder out of the exempt surplus of a foreign affiliate are taxed under an exemption system, meaning that no Canadian tax is imposed on such dividends (thus promoting capital import neutrality). In contrast, the Act taxes dividends paid to a Canadian corporate shareholder out of the taxable surplus of a foreign affiliate under a credit system, meaning that Canadian tax is imposed on such dividends, but only to the extent that the taxable surplus dividends are paid out of earnings that have not already been subjected to foreign tax at the assumed Canadian tax rate. FAPI earned by a controlled foreign affiliate is imputed directly to the Canadian shareholder (thus promoting capital export neutrality) and also adds to the foreign affiliate’s taxable surplus that is ultimately subject to tax in Canada (with corresponding relief for foreign tax and prior FAPI taxation) under the credit system.

The FAPI rules are effectively a set of anti-avoidance rules integrated with the hybrid exemption and credit systems for the taxation of dividends from foreign affiliates. The purpose of the FAPI rules is to eliminate any incentive for a Canadian-resident person to shift earnings of property income (assumed generally to be highly mobile) from Canada to an offshore controlled corporation in order to gain the advantage of potentially lower foreign tax rates on such income and the deferral of Canadian tax until the earnings are repatriated to Canada as taxable surplus dividends. In other words, the FAPI rules are designed to achieve capital export neutrality with respect to passive income sources of a Canadian taxpayer. The FAPI rules are generally understood not to be “tax-charging” or revenue-generating in their purpose—instead, the Canadian tax that potentially results under the FAPI rules is intended to neutralize the incentive to earn passive property income outside Canada.

As noted above, FAPI that is subject to current imputation includes, generally, income from property. This is defined in subsection 95(1) to include income from an “investment business,” which is defined in subsection 95(1) generally as income from a business the principal purpose of which is to earn income from property, subject to a number of important exceptions. Moreover, income that is otherwise income from property (and thus potentially included in FAPI) may be deemed instead to be active business income by virtue of the deeming rules in paragraph 95(2)(a) and thereby excluded from FAPI.

For the purposes of this article, however, the key component of FAPI is taxable capital gains from dispositions of property other than excluded property, to which none of the share exchange rollovers in paragraphs 95(2)(c), (d), or (e) apply.\(^7\)

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\(^7\) See item B of the definition of FAPI in subsection 95(1). This aspect of the FAPI definition is also the subject of proposed amendments in the February 27, 2004 draft legislation relevant to the topic of this article, as will be discussed below.
Excluded property (that is, property the gains from which are excluded from FAPI) includes assets used or held by the foreign affiliate principally for the purpose of gaining or producing income from an active business, intercompany amounts receivable where the interest would qualify for deemed active business treatment under subparagraph 95(2)(a)(ii), and shares of another foreign affiliate if “all or substantially all” of the property of the other foreign affiliate is excluded property. Thus, foreign affiliate shares will qualify as excluded property only if it can be established that more than 90 percent⁸ of the property of that foreign affiliate is itself excluded property.⁹ In a chain of foreign affiliates, non-qualifying assets (that is, assets that may not so clearly be used or held principally for the purpose of earning active business income) with a value exceeding the 10 percent threshold in any lower-tier affiliate can easily taint the excluded-property status of all the foreign affiliate shares in the chain above the tainted foreign affiliate. If it cannot be established that the property disposed of by a foreign affiliate qualifies under the strict definition of excluded property, any taxable capital gain realized by the controlled foreign affiliate (determined under Canadian principles and using Canadian dollars)¹⁰ will be included in FAPI and will accordingly be included in the Canadian shareholder’s income.

To alleviate the potential FAPI and surplus consequences that would otherwise result from dispositions in the course of routine foreign affiliate reorganizations, the Act provides relieving rollover rules for various share-for-share exchange transactions. Paragraph 95(2)(c) applies generally when a foreign affiliate disposes of shares of a second foreign affiliate to a third foreign affiliate in exchange for consideration that includes shares of the third affiliate. In these circumstances, the disposition is deemed to occur on a rollover basis for proceeds equal to the disposing affiliate’s cost of the shares (and therefore does not give rise to a taxable capital gain that would be FAPI) unless a higher proceeds amount is elected (by claiming a “relevant cost base”¹¹ in excess of the adjusted cost base of the shares). This share-for-share exchange rollover remains unchanged in the February 27, 2004 proposals. Paragraphs 95(2)(d) and (d.1) provide for similar FAPI rollovers when there is a merger of foreign affiliates. Paragraphs 95(2)(e) and (e.1) provide for FAPI rollovers when a lower-tier foreign affiliate liquidates and dissolves into another foreign affiliate, and

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⁸ The Canada Revenue Agency (CRA) generally considers that “all or substantially all” means 90 percent or more.

⁹ The February 27, 2004 amendments include a proposed change to the excluded-property definition that will clarify that foreign affiliate shares are excluded property only if all or substantially all of the fair market value of the property of the foreign affiliate is attributable to property of that foreign affiliate that is excluded property. A further change will broaden the intercompany amounts receivable category of excluded property to include property the income from which is deemed active business income under paragraph 95(2)(a).

¹⁰ See subparagraph 95(2)(f)(i), which clarifies that taxable capital gains of a foreign affiliate are computed using the rules in part I of the Act, in Canadian currency, when the property disposed of is not excluded property.

¹¹ As defined in subsection 95(4).
subsection 88(3) provides for a FAPI rollover when a top-tier foreign affiliate liquidates and dissolves into a Canadian-resident shareholder. The main point to observe at this juncture is that these FAPI rollover rules are currently designed to allow common foreign affiliate share reorganizations to occur in foreign jurisdictions, with potential relief from the income imputation consequences under the FAPI rules even if the foreign affiliate shares disposed of do not qualify under the strict definition of excluded property.

Summary of the February 27, 2004 Foreign Affiliate Proposals

As noted above, the February 27, 2004 draft legislation contains substantial and wide-ranging amendments to the foreign affiliate rules in the Act and regulations that go far beyond the topic of this article. However, an appreciation of the proposed changes to the foreign affiliate reorganization rules requires that these rules be viewed in their context of the more general February 27, 2004 foreign affiliate proposals, which may be categorized as dealing with the four broad themes described below.

Surplus and Loss Suspension Rules

One of the principal objectives of the proposals is to restrict and defer the realization of surplus balances or losses on certain intragroup asset transfers. For example, the proposed rules in paragraphs 95(2)(c.1) to (c.6) apply to intragroup dispositions (from a “specified vendor” to a “specified purchaser”) of foreign affiliate shares that are excluded property. In these circumstances, the vendor is deemed to have disposed of the excluded-property foreign affiliate shares for proceeds of disposition equal to the vendor’s adjusted cost base, forcing a rollover but giving rise to a “suspended gain” in respect of the excluded-property shares. This suspended gain is released upon certain triggering dispositions when the foreign affiliate shares are disposed of to unrelated parties, so that the surplus consequences occur at that later time. Specifically, these surplus suspension rules are intended to prevent the creation of exempt surplus through an internal or related-party disposition of excluded-property foreign affiliate shares. Under the current rules, one-half of the capital gain realized by the disposing affiliate (that is, the tax-exempt portion of the capital gain) is treated as exempt earnings (less any foreign tax applicable) and adds to the disposing affiliate’s exempt surplus; the balance (the taxable portion of the gain, net of foreign tax applicable) is treated as taxable earnings that add to taxable surplus. The proposed surplus suspension rules prevent this result by forcing the intragroup disposition to occur on a rollover basis. The surplus is recognized by the disposing foreign affiliate only on an arm’s-length disposition.

The same “suspended gain” rules apply under proposed paragraphs 95(2)(f.3) to (f.9) to intragroup transfers of other types of excluded property (for example,

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12 The part of the February 27, 2004 technical amendments package that deals with foreign affiliates contains over 100 pages of draft legislation, with an additional 90 pages devoted to draft regulations.
excluded property that is not shares of a foreign affiliate) in order to defer the creation of surplus until the time of a triggering disposition of the excluded property outside the group. In a similar manner, proposed paragraphs 95(2)(h) to (h.5) defer the realization of losses on intragroup transfers of non-excluded property that is not depreciable property or eligible capital property (that is, losses that would otherwise reduce FAPI) until the time of a triggering disposition of the property outside the group.

Changes to the Foreign Affiliate Liquidation and Merger Rollover Rules

At present, subsection 88(3) deals only with liquidations of controlled foreign affiliates. Under the proposed amendments, it will deal more generally with distributions of property from a top-tier foreign affiliate (no longer just a controlled foreign affiliate) to a Canadian-resident taxpayer on a dissolution and liquidation, a redemption of shares, the payment of a dividend, or other distributions of property (for example, capital distributions). In addition, substantial changes are proposed to the foreign merger rules in paragraphs 95(2)(d) and (d.1) and to the foreign affiliate liquidation rules in paragraphs 95(2)(e) and (e.1), but not to the current foreign affiliate share-for-share exchange rollover in paragraph 95(2)(c).

These proposed amendments are to a large extent intended to be consistent with and complement the new surplus and loss suspension rules in paragraphs 95(2)(c.1) to (c.6), (f.3) to (f.9), and (h) to (h.5). In particular, rollover treatment is forced for dispositions of excluded property in the course of a foreign merger or foreign affiliate liquidation, just as rollover treatment is forced for dispositions of excluded property in other intragroup dispositions. This aspect of the proposals is non-controversial. What is objectionable, I will argue, is the corollary of the forced rollover treatment for excluded property—namely, the denial of rollover treatment when the property disposed of is not excluded property, even if the property disposed of is shares of another foreign affiliate.

Consolidated Surplus and Deficit Computations

The February 27, 2004 proposals contain extensive new regulations that will change the manner in which surplus balances are calculated in regulation 5902 for the purposes of elections under subsection 93(1).\textsuperscript{13} The surplus balances of the foreign affiliate that issued the shares that are being disposed of will be computed on a

\textsuperscript{13} Subsection 93(1) provides for an election to treat all or a portion of a capital gain realized on a disposition of shares of a foreign affiliate as a dividend received from the foreign affiliate. This permits what is in effect a “surplus strip,” without actual payment of a dividend that could attract foreign withholding tax or otherwise be commercially undesirable. The effect of a subsection 93(1) election under the proposals is to reduce the capital gain otherwise resulting from the share disposition, up to the amount of the “attributed net surplus” balance of the foreign affiliate whose shares are disposed of. Proposed regulation 5902 contains detailed rules for determining how this consolidated surplus is calculated for the purposes of the subsection 93(1) election.
consolidated basis under the proposals, taking into account the relevant foreign affiliate’s proportionate share of exempt surpluses, taxable surpluses (and underlying foreign tax), exempt deficits, and taxable deficits of all lower-tier foreign affiliates in which the relevant foreign affiliate has an equity percentage. The purpose of these rules is to force a netting of deficit balances against surplus balances when determining the “attributed net surplus” of a foreign affiliate that may be accessed through the subsection 93(1) election mechanism.

**Subsection 95(2) Deeming Rules and Finance Comfort Letters**

The February 27, 2004 proposals contain numerous further technical amendments to the foreign affiliate rules, most of which were previously covered in the December 20, 2002 release and have been replicated or revised in the proposals. By way of example, these include refinements to the deemed active business income provisions in paragraph 95(2)(a), fresh-start rules applying to transitions from or to investment business status, and the implementation of various commitments made by the Department of Finance since 1994 respecting numerous (generally relieving) technical matters (including, for instance, amendments to clause 95(2)(a)(ii)(D)). Many of these amendments are the subject of the global section 95 election and the fresh-start election available to allow the taxpayer to treat discrete packages of amendments as being applicable to taxation years beginning after 1994.

With the foregoing overview as background, I will examine the specific proposed amendments to the foreign affiliate liquidation and merger rules in subsection 88(3) and paragraphs 95(2)(e), (e.1), (d), and (d.1). In each case I will focus first on the current provisions and then on the February 27, 2004 proposed amendments, including the recently announced modifications to the proposed amendments that are under consideration by Finance.

**Subsection 88(3): Liquidations of Top-Tier Foreign Affiliates**

**Current Subsection 88(3): Rollover for Distributions of Foreign Affiliate Shares**

At present, subsection 88(3) applies when, on the dissolution of a top-tier controlled foreign affiliate, shares of another foreign affiliate are transferred by the dissolving affiliate to the Canadian-resident taxpayer. In those circumstances, current paragraph 88(3)(a) deems the dissolving affiliate to have disposed of the distributed shares for proceeds of disposition equal to its adjusted cost base for the purposes of the Act, or such greater amount as the taxpayer claims, up to the fair market value of the distributed shares. This rule permits the taxpayer to treat the distribution of underlying foreign affiliate shares as a non-recognition event, or as a taxable disposition to the extent that the Canadian-resident taxpayer elects proceeds of disposition above the adjusted cost base. By virtue of paragraph 69(5)(a), the dissolving affiliate is deemed to have disposed of all other property (that is, all property other than foreign affiliate shares) distributed in the course of the dissolution for fair market
value proceeds of disposition, thereby realizing any accrued gain on such property.\textsuperscript{14} If the other distributed property is not excluded property, the gain of the dissolving controlled foreign affiliate will give rise to FAPI and the Canadian-resident taxpayer will suffer an income inclusion under subsection 91(1).

The cost to the Canadian-resident taxpayer of the underlying foreign affiliate shares distributed by the dissolving affiliate is deemed by paragraph 88(3)(a) to be the same as the proceeds of disposition of such shares to the dissolving affiliate (that is, the adjusted cost base of those shares, except to the extent that a higher amount is claimed by the taxpayer), effectively providing an opportunity to obtain a complete rollover in respect of any foreign affiliate shares distributed on the liquidation (whether or not the shares are excluded property). By virtue of paragraph 69(5)(b), the Canadian-resident taxpayer’s cost of any other property received on the winding up is equal to the property’s fair market value immediately before the winding up.

Current subsection 88(3) also provides that the Canadian-resident taxpayer’s proceeds of disposition of the shares of the dissolving controlled foreign affiliate are equal to the total of the cost to the taxpayer of the foreign affiliate shares received from the dissolving affiliate, plus the fair market value of any other property distributed on the dissolution, less the amount of the liabilities of the dissolving controlled foreign affiliate that were assumed or cancelled on the dissolution. In other words, the proceeds of disposition of the shares of the dissolving controlled foreign affiliate are equal to the taxpayer’s total cost of all property received on the dissolution. If that cost is higher than the Canadian-resident taxpayer’s adjusted cost base of the shares of the dissolving controlled foreign affiliate, the taxpayer will realize a gain. The broad rollover provided by current subsection 88(3) for distributions of foreign affiliate shares is illustrated and summarized in figure 1.

If the dissolving controlled foreign affiliate is a holding company (for example, a “surplus mixer”),\textsuperscript{15} the only assets of which are shares of other foreign affiliates of the taxpayer, the dissolution of the top-tier foreign affiliate will not give rise to any FAPI, regardless of the excluded-property status of the underlying shares. Moreover, the dissolution will not result in a gain for the Canadian taxpayer on the disposition

\textsuperscript{14} Regulation 5907(9)(b) provides the same fair market value disposition result, but only for the purpose of computing amounts referred to in regulation 5907, such as surplus and deficit balances.

\textsuperscript{15} It is common for Canadian-based multinationals to hold their shares of their foreign subsidiaries through a single top-tier holding company. This facilitates tax-effective distributions from the underlying foreign affiliates through to the Canadian parent company. Distributions out of exempt surplus and taxable surplus can be pooled or mixed in the holding company, such that distributions from the holding company may be treated under regulation 5901 as coming first out of exempt surplus, before accessing taxable surplus that could potentially give rise to Canadian tax when received by the Canadian parent if insufficient underlying foreign tax is applicable. In addition, such a holding company can be used to “blend” taxable surplus with associated high-rate underlying foreign tax with taxable surplus with associated low-rate underlying foreign tax; hence the use of the term “surplus mixer.”
of the shares of the dissolving controlled foreign affiliate so long as the “inside basis” (the adjusted cost base to the dissolving affiliate of the shares of the underlying foreign affiliates) does not exceed the “outside basis” (the adjusted cost base to the Canadian taxpayer of the shares of the dissolving affiliate).

Proposed Subsection 88(3): Rollover Restricted to Excluded-Property Foreign Affiliate Shares

Proposed subsection 88(3) (which, if enacted as proposed, will apply to property received after February 27, 2004) has been expanded in scope in two important ways. First, it will apply where the distributing corporation is a foreign affiliate of the Canadian taxpayer: it will no longer be restricted to distributions by controlled foreign affiliates. Second, it will apply to a broader range of distributions by a top-tier foreign affiliate. Specifically, it will apply to property received on a dissolution and liquidation (as is currently the case) as well as on a redemption of shares of the foreign affiliate, a payment of a dividend by the foreign affiliate, and a distribution of property by the foreign affiliate.\(^\text{16}\) I will focus on the manner in which proposed subsection 88(3) will apply to a liquidation and dissolution of a foreign affiliate.

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\(^{16}\) Although a “distribution of property” might be considered a broad term that would include distributions occurring on a liquidation, on a redemption, or on payment of a dividend, the context of proposed subsection 88(3) suggests (and Finance apparently intends to clarify) that the term “distribution of property” means a distribution other than the three enumerated types of distributions. For example, a “distribution of property” would include a distribution made as a formal return of capital by the top-tier foreign affiliate. This limited meaning of “distribution of property” is necessary to avoid the anomalous results that would be obtained if proposed paragraph 88(3)(f) (which includes the amount of a distribution of property in income to the extent that it does not result in a reduction of the adjusted cost base of the shares of the top-tier foreign affiliate resulting from a return of share subscription price or contributed surplus) were applied to distributions made on a liquidation or redemption of shares (the consequences
Proposed paragraph 88(3)(c) effectively replicates the current rule applicable to the Canadian-resident taxpayer in determining its proceeds of disposition of the shares of the dissolving foreign affiliate. In particular, the proceeds of disposition of the shares of the dissolving affiliate will be equal to the total cost to the Canadian taxpayer of distributed property received as consideration for the disposition of the shares, less the amount of the liabilities of the dissolving affiliate that were assumed or cancelled on the dissolution and liquidation.

However, proposed subsection 88(3) departs significantly from the current provision with respect to the treatment of the property disposed of by the dissolving foreign affiliate. Proposed paragraph 88(3)(a) will apply the rollover only to excluded-property foreign affiliate shares held by the dissolving affiliate. Consistent with the proposed surplus suspension rules, any such excluded-property foreign affiliate shares will be deemed disposed of on a forced rollover for proceeds of disposition equal to the dissolving affiliate’s adjusted cost base of the shares, unless the Canadian taxpayer elects to have the proceeds be some higher amount up to the fair market value of the shares. The deemed proceeds to the dissolving affiliate of the excluded-property shares become the Canadian taxpayer’s cost of the shares by virtue of proposed subparagraph 88(3)(a)(ii). Proposed paragraph 88(3)(b) deems any other property of the dissolving affiliate to have been disposed of for fair market value proceeds of disposition, which also becomes the Canadian taxpayer’s cost of such other distributed property. The scope of property currently deemed to be disposed of for fair market value proceeds is thus expanded by proposed paragraph 88(3)(b) to include foreign affiliate shares that are not excluded property. This is illustrated in figure 2.

Implications of Proposed Subsection 88(3)
If these changes are implemented as proposed, the subsection 88(3) rollover currently available on a liquidation and dissolution of a top-tier controlled foreign affiliate for any shares of a foreign affiliate distributed to the Canadian taxpayer will

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17 The rule in proposed paragraph 88(3)(c) will also apply to determine the Canadian taxpayer’s proceeds of disposition of foreign affiliate shares disposed of on the redemption, acquisition, or cancellation of shares of the foreign affiliate. There is a minor drafting inconsistency: the subsection 88(3) preamble refers only to a redemption of shares, not to the acquisition or cancellation of shares of the foreign affiliate.

18 Although the election to recognize a gain is similar to the election in current subsection 88(3), it is now clear that the election in proposed paragraph 88(3)(a) will give rise to FAPI, pursuant to subclause (b) of item B of the amended FAPI definition in subsection 95(1), which in its current form does not refer to subsection 88(3).
be restricted to foreign affiliate shares that are excluded property. Although this change does not adversely affect liquidations of foreign affiliates that are not controlled foreign affiliates (which are currently fully taxable because the existing subsection 88(3) rollover does not apply), it is potentially a very inhibiting amendment for liquidations of a top-tier controlled foreign affiliate, which will now result in the realization of FAPI if the underlying foreign affiliate shares distributed to the Canadian taxpayer on the liquidation are not excluded property and there is an accrued gain on the shares.\(^{19}\) It will no longer be sufficient for a taxpayer to ensure, on a liquidation of a top-tier controlled foreign affiliate pure holding company that owns shares of other foreign affiliates, that the “inside basis” is no greater than the “outside basis”; it will now also be necessary to confirm that all of the shares of the underlying foreign affiliates that are distributed to the Canadian taxpayer are excluded property, if the offshore liquidation is to occur on a rollover basis without potentially creating a Canadian tax liability.\(^{20}\)

\(^{19}\) However, note that by virtue of proposed subsections 93(1.1) and (1.4), a subsection 93(1) election will be deemed to have been made in respect of the disposition by the dissolving foreign affiliate of the underlying non-excluded-property shares. Subsection 93(1.1) is amended to automatically deem the election to be made in respect of a disposition of any underlying foreign affiliate shares (not only shares that are excluded property, as is currently the case), and subsection 93(1.4) is added to preclude an election if the disposition results from paragraph 88(3)(a). The disposition of the underlying non-excluded-property foreign affiliate shares occurs at fair market value pursuant to paragraph 88(3)(b) and accordingly is not precluded. The effect of the automatic subsection 93(1) election is to potentially reduce the amount of gain (and FAPI) realized, to the extent of the underlying foreign affiliate’s “attributed net surplus” in respect of the Canadian taxpayer, computed in accordance with the amended consolidated surplus and deficit calculation rules in regulation 5902.

\(^{20}\) If the “inside basis” exceeds the “outside basis” and a gain results under paragraph 88(3)(c) on the disposition of the shares of the dissolving foreign affiliate, the taxpayer may be able to
By way of an example to illustrate the practical implications of this proposal, consider a group of foreign corporations held by a Canadian parent corporation through one or more “surplus mixer” foreign holding corporations. The top-tier holding corporation is generally situated in a low-tax jurisdiction that does not impose income tax on (or contains broad exemptive relief for) dividends received from underlying foreign affiliates and that does not impose withholding tax (or has low rates of withholding tax, either domestically or by virtue of a tax treaty with Canada) on dividends paid to the Canadian parent corporation. From time to time, there may be changes in the relevant foreign tax law applicable to the top-tier offshore holding company, changes to the foreign regulatory regime, or other developments that make it desirable for the Canadian parent corporation to reorganize the holding structure of its foreign affiliates by using a corporation in a different jurisdiction as the top-tier “surplus mixer” foreign affiliate. Under current subsection 88(3), the Canadian parent corporation can effectively and flexibly restructure the group by liquidating the top-tier offshore holding company without the risk of triggering FAPI (because—by assumption, in this example—as a holding company its only assets are shares of other foreign affiliates), and with the limited potentially adverse Canadian tax consequence of triggering a capital gain on the shares of the liquidating foreign affiliate only if and to the extent that the inside basis exceeds the outside basis.21

In contrast, under proposed subsection 88(3), the Canadian parent corporation will suffer a FAPI inclusion if any of the shares of the underlying foreign affiliates distributed on the liquidation are determined to be non-excluded property and there is an accrued gain on those shares which is not fully eliminated by an automatic subsection 93(1) election. If any of the shares with significant accrued gain are not excluded property, the potential Canadian tax costs of completing the reorganization may cause the Canadian parent corporation not to proceed with the reorganization. Even when the Canadian parent corporation undertakes an exhaustive analysis and concludes that the shares are excluded property, the risk could be prohibitive if there is a possibility that the factual basis of that analysis could be incorrect. Some Canadian parent corporations could be forced to retain undesirable holding structures, or they could be required to incur additional costs for foreign affiliate reorganizations that do proceed. (For example, detailed excluded-property status reviews may have to be undertaken for every corporation in the offshore group; and the Canadian parent may assume a Canadian tax risk if the top-tier foreign affiliate reorganization

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21 If the Canadian parent company wished to use a new corporation as its top-tier surplus mixer, it would dissolve the old surplus mixer on a rollover basis under current subsection 88(3), and then transfer the shares of the underlying foreign affiliates to the new surplus mixer using the share-for-share exchange rollover in subsection 85.1(3).
is undertaken on the basis of excluded-property determinations that are contested by the Canada Revenue Agency (CRA) or ultimately found to be incorrect.)

**Modifications Under Consideration by Finance**

At the May 9, 2005 IFA seminar, Finance indicated that it is considering modifications to the changes to subsection 88(3) that were proposed in the February 27, 2004 draft legislation. In particular, Finance indicated that it may provide the taxpayer with a “relevant cost base” election for determining the proceeds of disposition to the liquidating foreign affiliate of all property (not just excluded property) distributed in the course of the liquidation and dissolution. However, this elective relief would be available only if the Canadian taxpayer had a 90 percent or greater (measured by fair market value) participating equity interest in the liquidating foreign affiliate. Presumably, this 90 percent restriction is intended to make the subsection 88(3) FAPI rollover available in circumstances analogous to those in which the domestic liquidation rollover in subsection 88(1) is available. If these modifications are adopted, they will address the “surplus mixer” liquidation issues described above in the context of a wholly owned foreign affiliate group. They will nevertheless result in curtailment of the existing FAPI rollover relief when non-excluded-property foreign affiliate shares are distributed to the Canadian parent on the liquidation of a foreign affiliate in which the parent owns less than a 90 percent interest.

In addition, Finance indicated at the May 9, 2005 IFA seminar that further modifications are being considered in respect of the treatment of the shares of the liquidating affiliate held by the parent (also relevant to paragraph 95(2)(e) and (e.1) liquidations of lower-tier foreign affiliates). Under these modifications, all distributions by a foreign affiliate to a shareholder in respect of a share would be treated as a corporate distribution, whether the share is redeemed, acquired, or cancelled or the foreign affiliate is liquidated. Such distributions would be treated first as a return of foreign paid-up capital, then as a dividend out of exempt and taxable surplus, and finally as a dividend out of pre-acquisition surplus. If adopted, this rule may permit the taxpayer to access foreign “paid-up capital” and surplus balances before grinding the adjusted cost base of the shares of the liquidating foreign affiliate, ultimately resulting in a potential capital gain by virtue of subsection 40(3). On the other hand, by treating the liquidating affiliate as having paid a dividend out of its surplus balances, this rule could have the effect of forcing the taxpayer to receive a taxable surplus dividend where there may be insufficient underlying foreign tax to fully shelter the section 90 income inclusion with a paragraph 113(1)(b) deduction.\(^{22}\)

\(^{22}\) The proposed treatment of corporate distributions may also address concerns (albeit outside the context of a liquidation) that a subsection 15(1) taxable benefit could arise where a top-tier foreign affiliate makes a distribution to its Canadian parent that is not clearly treated under foreign law as a dividend or return of capital.
Further details regarding these modifications under consideration in respect of subsection 88(3) were released in two nearly identical Finance comfort letters dated August 16, 2005.\textsuperscript{23} Finance would allow the taxpayer to elect to apply the alternative rules to a “qualifying liquidation and dissolution” of a foreign affiliate that begins after February 27, 2004. A “qualifying liquidation and dissolution” would arise where the Canadian taxpayer held shares of the foreign affiliate having at least 90 percent of the voting rights at a general meeting of shareholders in all circumstances, and received properties having a fair market value equal to at least 90 percent of the total fair market value of all properties distributed to shareholders by the foreign affiliate in the course of the liquidation and dissolution. This “90 percent of votes and value” threshold differs from the “90 percent fair market value” test originally suggested in the May 9, 2005 IFA seminar materials. Under the alternative rules, all properties of the liquidating foreign affiliate would be deemed disposed of for proceeds equal to the greater of the “relevant cost amount” (in which case no gain would be realized) and the amount elected by the taxpayer up to the fair market value of the property. Any such elected income or taxable capital gain would be included in FAPI. The Canadian taxpayer would receive the distributed properties at a cost equal to the liquidating affiliate’s deemed proceeds. Importantly, the liquidating foreign affiliate would be considered to have made a distribution to the Canadian taxpayer in an amount equal to this cost, less certain liabilities of the liquidating foreign affiliate that are assumed or cancelled by the taxpayer as a result of the liquidation, and less the cost of any properties received by the liquidating foreign affiliate from the taxpayer as consideration for the distributed property. The deemed amount of the distribution in respect of a particular share would be treated first as a return of paid-up capital in respect of the share, to the extent of the “foreign paid-up capital,” which would generally be the particular share’s portion of amounts contributed by the foreign affiliate’s shareholders to the foreign affiliate, provided that those contributions were in respect of shares issued to or held by those shareholders. Any excess of the deemed distribution amount over the foreign paid-up capital would then be treated as a dividend paid by the foreign affiliate to the taxpayer. Interestingly, the comfort letters do not indicate expressly the intended treatment of the shares of the liquidating affiliate that are cancelled when the affiliate is dissolved.

The comfort letters give the impression that Finance is considering the implementation of two parallel sets of rules for top-tier foreign affiliate liquidations. The first set of rules would be as released on February 27, 2004, with the denial of rollover treatment for distributions of non-excluded-property foreign affiliate shares. The second set of rules would be as described in the comfort letters, but would be available to a taxpayer by election only where the “90 percent of votes and value”

\textsuperscript{23} Each of the August 16, 2005 comfort letters is headed “Distribution of Property of a Foreign Affiliate When Liquidation or Dissolution” and is authored by Brian Ernewein. The text of the two letters is identical except that they are in response to taxpayer letters of two different dates.
test is satisfied in respect of the foreign affiliate. In these circumstances, the taxpayer would be permitted to access a rollover for property distributed on the liquidation, but would be treated as having received a distribution that could pull up taxable surplus with insufficient underlying foreign tax.

**Paragraphs 95(2)(e) and (e.1): Liquidations of Lower-Tier Foreign Affiliates**

*Current Paragraphs 95(2)(e) and (e.1)*

Paragraphs 95(2)(e) and (e.1) apply to certain liquidations of lower-tier foreign affiliates, where the parent corporation is another foreign affiliate of the Canadian-resident taxpayer, as opposed to the Canadian-resident taxpayer itself (the circumstances covered by subsection 88(3)). The general rule is found in paragraph 95(2)(e), which will apply unless the more specific rule in paragraph 95(2)(e.1) is applicable.

*Paragraph 95(2)(e): Rollover for Distributions of Foreign Affiliate Shares*

The general rule in paragraph 95(2)(e) applies if, on the dissolution of a foreign affiliate of a Canadian taxpayer, shares of an underlying foreign affiliate are disposed of to a shareholder of the dissolving affiliate that is also a foreign affiliate of the Canadian taxpayer. Subparagraph 95(2)(e)(i) provides that the dissolving affiliate’s proceeds of disposition of the underlying foreign affiliate shares (whether or not they are excluded property) and the shareholder affiliate’s cost of those shares are each equal to the dissolving affiliate’s relevant cost base of the underlying foreign affiliate shares. Thus, the dissolving affiliate will dispose of the underlying foreign affiliate shares on a tax-deferred rollover basis, unless the taxpayer elects out of the rollover treatment.

By virtue of paragraph 69(5)(a), any other property of the dissolving affiliate (that is, any property other than foreign affiliate shares) will be deemed disposed of for fair market value proceeds of disposition. Paragraph 69(5)(b) deems the shareholder affiliate to have acquired the distributed property for a cost equal to the fair market value proceeds to the dissolving affiliate. Thus, under the limited rollover in paragraph 95(2)(e), only foreign affiliate shares may be distributed on a rollover basis; other assets are distributed on a taxable basis.24

Subparagraph 95(2)(e)(ii) deems the shareholder affiliate to have disposed of the shares of the dissolving affiliate for proceeds equal to its cost of the underlying foreign affiliate shares received on the dissolution, plus the fair market value of any other property distributed to the shareholder affiliate on the dissolution, less the

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24 Regulation 5907(9) provides the same fair market value disposition and acquisition result for property other than foreign affiliate shares, but only for the purposes of computing surplus and deficit amounts.
amount of any liabilities of the dissolving affiliate that are assumed or cancelled by
the shareholder on the dissolution. If the shareholder affiliate realizes a capital gain
on the disposition of the shares of the dissolving affiliate, the taxable capital gain is
included in FAPI, even if the disposed shares are excluded property, by virtue of
item B of the FAPI definition in subsection 95(1). Therefore, if the dissolution of a
foreign affiliate that is a pure holding company does not qualify for the more
generous rollover treatment in paragraph 95(2)(e.1), the Canadian taxpayer may
avoid FAPI on the dissolution so long as the “outside basis” (the shareholder affiliate’s
adjusted cost base of the shares of the dissolving affiliate) is at least as large as the
dissolving affiliate’s “inside basis” (the adjusted cost base of the shares of the underly-
ing foreign affiliates, whether or not they are excluded property). The application
of current paragraph 95(2)(e) is illustrated and summarized in figure 3.

Paragraph 95(2)(e.1): Broad Rollover in
Limited Circumstances

Paragraph 95(2)(e.1) provides broader non-recognition treatment for a liquidation
and dissolution of a foreign affiliate where the Canadian taxpayer’s surplus entitle-
ment percentage in respect of the dissolving affiliate is at least 90 percent and
where the liquidation effectively qualifies for non-recognition treatment under the
tax laws of the country in which the dissolving affiliate is resident (specifically, non-
recognition is required under the foreign law in respect of all capital property
distributed by the dissolving affiliate to a shareholder affiliate resident in the same
country as the dissolving affiliate).25 If these conditions are met, each capital property
of the dissolving affiliate (not limited to shares of underlying foreign affiliates as in
paragraph 95(2)(e)) is deemed disposed of for proceeds equal to the cost amount of
the property to the dissolving affiliate. The shareholder affiliate’s proceeds of dispos-
ton of the shares of the dissolving affiliate are deemed to be equal to their adjusted
cost base, without gain (and potentially FAPI) being realized as in paragraph 95(2)(e)
if the inside basis exceeds the outside basis. Therefore, a liquidation and dissolu-
tion of a lower-tier foreign affiliate that meets the 90 percent surplus entitlement
and foreign non-recognition conditions of paragraph 95(2)(e.1), and that holds
only shares of underlying foreign affiliates as capital property (as is generally the
case for a foreign holding company), may be accomplished on a complete rollover
basis for the purposes of the Act. The application of current paragraph 95(2)(e.1) is
summarized and illustrated in figure 4.

25 Interestingly, the non-recognition condition is satisfied on a taxable cross-border foreign affiliate
dissolution, because the property is distributed to a shareholder foreign affiliate resident in a
different country. Non-recognition is required only for distributions to a shareholder affiliate
resident in the same country. As a result, the rollover provisions of current paragraph 95(2)(e.1)
will apply to a taxable cross-border dissolution so long as the 90 percent surplus entitlement
test is satisfied. See, for example, CRA document no. 9912965, November 24, 1999.
FIGURE 3  Current Paragraph 95(2)(e)

Canco

FA 1

Liquidating distribution of FA 2

Disposition at aggregate cost to FA 1 of distributed property less liabilities (gain is FAPI)

FA 2

Rollover at ACB (or higher elected amount)

Taxable FMV disposition

FA (excluded property)

FA (non-excluded property)

FIGURE 4  Current Paragraph 95(2)(e.1)

Canco

>90%

CFA 1

Liquidating distribution of CFA 2 (must be foreign rollover)

>90%  Rollover at ACB

CFA 2

Rollover at cost

FA (excluded property)

Rollover at cost

Capital property (non-share)

Rollover at cost

FA (non-excluded property)
Proposed Paragraphs 95(2)(e) and (e.1)
The proposed foreign affiliate rules include (1) substantial amendments to the general rules in paragraph 95(2)(e) applicable to lower-tier foreign affiliate dissolutions; (2) technical amendments to the specific rules in paragraph 95(2)(e.1) that were previously released in the December 20, 2002 technical amendments; (3) new paragraphs 95(2)(e.2) to (e.6); 26 and (4) corresponding amendments to the surplus and deficit calculation rules in regulation 5907(9) (plus the introduction of regulation 5907(9.1)).

In the following discussion, I will focus on the proposed rules that apply specifically to a liquidation and dissolution of a lower-tier foreign affiliate.

Retention of the Paragraph 95(2)(e.1) Broad Rollover
Proposed paragraph 95(2)(e.1) essentially preserves the comprehensive rollover in the current provision. However, the deemed disposition of distributed property at the dissolving foreign affiliate's cost amount is extended to all property of the dissolving affiliate distributed to another foreign affiliate and is no longer limited to distributions of capital property. The requirement that the liquidation and dissolution be accorded non-recognition treatment in respect of a distribution to a shareholder foreign affiliate that is resident in the same country as the dissolving affiliate has been broadened, so that the shareholder affiliate need no longer be resident in the same country as the dissolving affiliate in order to be denied the rollover relief in paragraph 95(2)(e.1). This will have the effect of precluding the application of the paragraph 95(2)(e.1) rollover to taxable cross-border foreign affiliate liquidations that currently benefit from the rollover. Amended paragraph 95(2)(e.1) will apply to liquidations beginning after December 20, 2002, on the basis that the current proposal is essentially unchanged from the initial proposal released on December 20, 2002.

Paragraph 95(2)(e): Rollover Restricted to Excluded Property
The key proposed amendments applicable to lower-tier foreign affiliate liquidations are found in proposed paragraph 95(2)(e), which will apply to liquidations beginning after February 27, 2004. Broadly speaking, there are three key changes.

26 New paragraph 95(2)(e.2) provides that the liquidation rules in paragraph 95(2)(e.1) will apply to certain redemptions of foreign affiliate shares where the Canadian taxpayer's surplus entitlement percentage is reduced from more than 90 percent to nil or where property representing at least 90 percent of the fair market value of the foreign affiliate is distributed to its shareholders. New paragraphs 95(2)(e.3) to (e.5) apply where certain intragroup dividends or share redemption distributions are made (other than in the course of a liquidation and dissolution of a foreign affiliate or a foreign merger) and effectively force a rollover in respect of excluded property and a disposition at fair market value for all other types of distributed property. New paragraph 95(2)(e.6) provides partnership attribution rules, for the purposes of the general foreign affiliate liquidation rule in paragraph 95(2)(e) and the new rules in paragraphs 95(2)(e.3) to (e.5), where foreign affiliate shares are owned by a partnership or where a foreign affiliate is a member of a partnership. The foregoing rules are for the most part analogous to and extensions of the surplus suspension rules previously referred to in paragraphs 95(2)(c.1) to (c.6) and (f.3) to (f.9), but they are outside the scope of this discussion of foreign affiliate liquidations.
First, whereas current paragraph 95(2)(e) applies on the dissolution of a foreign affiliate when there is a disposition of underlying foreign affiliate shares to a shareholder that is another foreign affiliate of the Canadian taxpayer, proposed paragraph 95(2)(e) will apply more generally when, in the course of a liquidation and dissolution to which paragraph 95(2)(e.1) does not apply, a specified purchaser in respect of a corporation resident in Canada receives any property from the dissolving foreign affiliate. For this purpose, “specified purchaser” is defined in new subsection 95(3.2)27 to mean the relevant Canadian corporation, a Canadian-resident taxpayer not dealing at arm’s length with the Canadian corporation, a foreign affiliate of the Canadian corporation or non-arm’s-length taxpayer, a non-arm’s-length non-resident person, and certain trusts and partnerships.28 Thus, the scope of shareholder recipients of property from the dissolving affiliate has been broadened, and the rule will apply when any property—not only underlying foreign affiliate shares—is distributed on the liquidation.29

The second key change affects the rule in current paragraph 95(2)(e), which deems all underlying foreign affiliate shares (whether or not they are excluded property) that are distributed on the liquidation to be disposed of at the relevant cost base (the adjusted cost base, unless a higher amount is claimed) of the dissolving affiliate. Instead, proposed subparagraph 95(2)(e)(i) will deem only excluded property of the dissolving affiliate to be disposed of for proceeds equal to the relevant cost base, with all other property being disposed of for fair market value proceeds. Thus, the existing rollover for underlying foreign affiliate shares that are not excluded property will be removed if paragraph 95(2)(e) is enacted as proposed.

The forced rollover for excluded property distributed on a foreign affiliate liquidation to a specified purchaser is the analogue to the new surplus suspension rules in paragraphs 95(2)(c.1) to (c.6) and 95(2)(f.3) to (f.9), which by virtue of subparagraphs 95(2)(c.1)(iv) and 95(2)(f.6)(i) expressly do not apply to foreign affiliate liquidations governed by paragraphs 95(2)(e) and (e.1). The difference is that

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27 Although subsection 95(3.2) as drafted is stated to apply for the purposes of paragraphs 95(2)(e.2) to (e.5), among other provisions, but not for the purposes of paragraph 95(2)(e), the explanatory notes in respect of paragraph 95(2)(e) indicate that the definition in subsection 95(3.2) is intended to apply. Presumably this minor drafting inconsistency will be remedied in future versions of the draft legislation.

28 The definition of “specified purchaser” includes certain Canadian-resident persons; however, the introductory words of proposed paragraph 95(2)(e) preclude its application when the shareholder of the dissolving foreign affiliate is a person resident in Canada. Therefore, proposed paragraph 95(2)(e) will not overlap with proposed subsection 88(3).

29 Interestingly, one consequence of the use of the “specified purchaser” concept, which applies only in respect of a Canadian-resident corporation (and not in respect of other Canadian-resident taxpayers, such as individuals), is that proposed paragraph 95(2)(e) will no longer apply to a liquidation of a foreign affiliate in respect of a Canadian-resident individual. Such a liquidation of a lower-tier foreign affiliate of a non-corporate Canadian-resident shareholder will occur on a taxable basis for the purposes of the Act unless the liquidation qualifies for the relief in paragraph 95(2)(e.1).
although paragraphs 95(2)(c.2) and (f.4) cause the specified purchaser to have the fair market value cost of the excluded property and the vendor to have a suspended gain that is realized only upon certain “triggering disposition” events, paragraph 95(2)(e) forces a permanent rollover of the excluded property distributed to a specified purchaser on the liquidation with respect to both the dissolving foreign affiliate and the specified purchaser, which acquires the excluded property at a cost that is equal to the relevant cost base of the dissolving affiliate (and not stepped up to fair market value).

Proposed subparagraph 95(2)(e)(ii) continues the existing rule that deems the shareholder’s cost of property received on the liquidation to be equal to the dissolving affiliate’s proceeds of disposition,30 but subparagraph 95(2)(e)(iii) deems such property to be received by the shareholder as proceeds of disposition of the shares of the dissolving affiliate in the course of the liquidation and dissolution. Subparagraph 95(2)(e)(iv) deems the amount of these proceeds to be essentially the same as that provided in current paragraph 95(2)(e)—namely, the total cost to the shareholder of all properties received from the dissolving affiliate as consideration for the disposition of the shares in the course of the liquidation and dissolution, less the amount of liabilities of the dissolving affiliate assumed or cancelled by the shareholder on the liquidation, except that the aggregate proceeds are expressly allocated among all shares of the dissolving affiliate that are disposed of in the course of the liquidation and dissolution in proportion to their fair market value. Where the shareholder foreign affiliate realizes a capital gain from the disposition of the shares of the dissolving affiliate for these deemed proceeds, subsection 93(1.1) will apply to deem the Canadian corporate taxpayer to have made an election under subsection 93(1). This will reduce the capital gain to the extent of the “attributed net surplus” of the dissolving foreign affiliate computed on a consolidated basis under the new rules in regulation 5902. However, any remaining taxable capital gain will be included in the shareholder affiliate’s FAPI, subject to the new election described below.

The third key change is found in proposed subparagraph 95(2)(e)(v), which introduces a rule that applies when the shares of the dissolving affiliate that are disposed of in the course of the liquidation are excluded property of the shareholder. In these circumstances, the shareholder’s gain from the disposition is deemed to be the lesser of the gain otherwise determined and the amount of gain elected by the relevant Canadian corporation. Any gain that is not reduced to nil by virtue of this election and any automatic subsection 93(1) election will give rise to FAPI (to the extent of the taxable capital gain) pursuant to item B of the revised FAPI definition in subsection 95(1), notwithstanding that the shares disposed of are excluded property.

The proposed changes to paragraph 95(2)(e) are illustrated in figure 5.

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30 The proposed amendments to regulation 5907(9) would, for surplus calculation purposes, deem a fair market value disposition and acquisition cost for any property distributed on the liquidation, subject to the overriding rules in paragraphs 95(2)(e) and (e.1).
Implications of Proposed Paragraph 95(2)(e)

Because the existing foreign affiliate liquidation rollover provisions in paragraph 95(2)(e.1) remain intact (and indeed are expanded by the extension of the rollover to all property—not just capital property—distributed by the dissolving foreign affiliate on the liquidation), it will be possible to complete the liquidation of a foreign affiliate under that provision on a full rollover basis without the risk of triggering FAPI in the dissolving affiliate (which is deemed to dispose of all property at its cost amount) or in the shareholder affiliate (which is deemed to dispose of the shares of the dissolving affiliate for proceeds equal to their adjusted cost base). The difficulty is that the paragraph 95(2)(e.1) liquidation rollover, even in its broadened form, applies only in very specific circumstances—namely, where the Canadian taxpayer has at least a 90 percent surplus entitlement percentage in respect of the dissolving foreign affiliate, and the liquidation (whether domestic or cross-border) is accorded complete non-recognition treatment under the tax law of the country in which the dissolving affiliate is resident.31 In any other foreign affiliate liquidation where

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31 The 90 percent surplus entitlement condition is particularly troublesome. Under the current rules in regulations 5905(10) to (13) for determining a taxpayer’s surplus entitlement percentage in respect of a foreign affiliate, a taxpayer with an “economic interest” in a foreign affiliate exceeding 90 percent can nonetheless fall below the 90 percent surplus entitlement threshold...
these strict conditions are not met, the taxpayer must rely on the rollover provisions of proposed paragraph 95(2)(e), which have been significantly narrowed.

Most importantly, paragraph 95(2)(e) will no longer provide a rollover for the distribution of foreign affiliate shares that are not excluded property. If the dissolving affiliate realizes a gain from the deemed fair market value disposition of any such shares or any other non-excluded property (as is the case under current paragraph 95(2)(e)), the taxable capital gain will be FAPI potentially taxable in the hands of the Canadian taxpayer.32

In addition, the restricted paragraph 95(2)(e) rollover will be available only to Canadian corporate taxpayers by virtue of the requirement that the shareholder of the dissolving foreign affiliate be a “specified purchaser” in respect of a corporation resident in Canada. Thus, individuals, trusts, and partnerships that hold offshore foreign affiliate groups will generally be precluded from accessing the revised paragraph 95(2)(e) rollover.

The effect of narrowing the scope of the paragraph 95(2)(e) rollover is to further reduce the ability of Canadian taxpayers to reorganize the holding structures of their offshore foreign affiliate groups without triggering Canadian tax. Foreign liquidations will continue to be possible on a rollover basis under paragraph 95(2)(e.1) in wholly owned groups (with a 100 percent surplus entitlement percentage) so long as the liquidation is tax-deferred in the foreign jurisdiction. But in many circumstances these strict conditions will not be met. The 90 percent surplus entitlement requirement will not be satisfied in a typical offshore joint venture, or where there are minority investors (including employees), or where there are preferred shares outstanding to third parties; but in many such cases, the dissolving foreign affiliate may still be a controlled foreign affiliate such that FAPI realized from the distribution of non-excluded property will trigger Canadian tax for the Canadian taxpayer. Moreover, not all liquidations are fully tax-deferred in the local jurisdiction.

If for reasons unrelated to Canadian tax it is desirable for a foreign affiliate to be liquidated, and if the strict conditions of paragraph 95(2)(e.1) are not satisfied, the Canadian taxpayer will have to incur the costs of an excluded-property analysis respecting the shares of underlying foreign affiliates (and other properties) to be distributed on the liquidation; the taxpayer will be exposed to the risk of triggering

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32 If a gain is realized on the deemed disposition of non-excluded-property foreign affiliate shares at fair market value under subparagraph 95(2)(e)(i), there is no possibility of reducing the gain pursuant to the automatic subsection 93(1) election under subsection 93(1.1) by virtue of subsection 93(1.4), which precludes the subsection 93(1) election in such circumstances.
Canadian tax as a result of the foreign affiliate liquidation if any of the distributed assets are found not to be excluded property. As with top-tier foreign affiliate liquidations under subsection 88(3), the effect of the narrowed lower-tier foreign affiliate liquidation rollover in paragraph 95(2)(e) may be to preclude liquidations that would otherwise occur but for the adverse Canadian tax results or risks.

**Modifications Under Consideration by Finance**

At the May 9, 2005 IFA seminar, Finance indicated that it is considering broadening the application of subsection 95(2)(e.1) by eliminating the “no foreign tax recognition” requirement. The 90 percent surplus entitlement condition would be retained, although the condition would be considered satisfied when a foreign affiliate of the taxpayer has a 90 percent or greater (by fair market value) participating interest in the liquidating foreign affiliate, even if the Canadian taxpayer itself does not have a 90 percent surplus entitlement in respect of the liquidating foreign affiliate. If these changes are adopted, the broad rollover relief in paragraph 95(2)(e.1) will apply in certain joint venture contexts where the parent foreign affiliate (itself owned less than 90 percent by the Canadian parent) has at least a 90 percent ownership interest in the liquidating foreign affiliate, and in the case of a taxable liquidation of a foreign affiliate in a wholly owned group. The rollover relief will not apply, however, if the liquidating foreign affiliate itself is the joint venture entity such that no foreign affiliate of the Canadian taxpayer has at least a 90 percent ownership interest. Like the possible changes to subsection 88(3), these proposed modifications are apparently intended to bring the conditions for rollover relief on foreign affiliate liquidations into conformity with the conditions for domestic corporate liquidation relief in subsection 88(1), which also requires a 90 percent or greater ownership position.

In addition, although existing and proposed paragraphs 95(2)(e.1) provide for a mandatory rollover of property distributed by the liquidating foreign affiliate, Finance is considering allowing the Canadian taxpayer to elect a disposition at the relevant cost base, such that any elected gain recognized would be included in FAPI.

Finally, as noted above in the context of proposed subsection 88(3), Finance is considering modifications to the treatment of the shares of the liquidating foreign affiliate under paragraphs 95(2)(e) and (e.1), such that distributions by a foreign affiliate in the course of its liquidation and dissolution (as well as on the redemption or cancellation of a share or as a corporate distribution) would be treated first as a return of foreign paid-up capital, then as a dividend out of exempt and taxable surplus, and finally as a dividend out of pre-acquisition surplus.

In the case of a lower-tier foreign affiliate liquidation, the possible deemed payment of a dividend out of the taxable surplus of the liquidating affiliate does not raise the same concerns as discussed above in the context of a top-tier foreign affiliate liquidation under subsection 88(3). Even if relatively low underlying foreign tax is associated with the taxable surplus dividend, no Canadian tax would arise as a direct result of a taxable surplus dividend deemed paid on a lower-tier liquidation under these possible modifications.
PARAGRAPHS 95(2)(d) AND (d.1): MERGERS OF LOWER-TIER FOREIGN AFFILIATES

Current Paragraphs 95(2)(d) and (d.1)

Foreign Mergers

Paragraphs 95(2)(d) and (d.1) apply to certain “foreign mergers” as defined in subsection 87(8.1) by virtue of subsection 95(4.1). A foreign merger is effectively a merger or combination of two or more non-resident corporations to form one new foreign corporation, if all or substantially all of the property and liabilities of the predecessor foreign corporations become property and liabilities of the new foreign corporation, and all or substantially all of the shares of the predecessor foreign corporations are exchanged for or become shares of the new foreign corporation (or shares of a parent foreign corporation, thereby facilitating foreign triangular mergers).

The rules applicable to foreign mergers are analogous in several respects to the lower-tier foreign affiliate liquidation rules in paragraphs 95(2)(e) and (e.1). Paragraph 95(2)(d) contains the general (more limited) rollover provisions applicable to certain foreign mergers. Paragraph 95(2)(d.1) contains a more specific rule conferring broader rollover treatment on a more limited category of foreign mergers. The rules overlap: the consequences of a foreign merger that meets the strict conditions of paragraph 95(2)(d.1) are determined in part under that paragraph, and under paragraph 95(2)(d) to the extent that they are not determined under paragraph 95(2)(d.1).

Paragraph 95(2)(d) Foreign Affiliate Share Rollover

The general rules in paragraph 95(2)(d) apply to a foreign merger where a foreign affiliate of a Canadian-resident taxpayer holds shares of a predecessor foreign corporation that are exchanged for or become shares of the new foreign corporation (or the foreign parent corporation, in a triangular merger). The predecessor foreign corporation need not be a foreign affiliate of the Canadian taxpayer, but the shareholder must be a foreign affiliate. In these circumstances, the provisions of subsection 87(4) apply to the shareholder foreign affiliate (with contextual modifications) to deem shares of a predecessor foreign corporation that are capital property to be disposed of by the shareholder affiliate for proceeds equal to their relevant cost base (the adjusted cost base, unless a higher amount is claimed by the taxpayer) and to deem the shareholder affiliate to have acquired the shares of the new foreign corporation (or the foreign parent corporation) at a cost equal to the shareholder’s aggregate proceeds of disposition, allocated pro rata among classes of stock of the new foreign corporation (or the foreign parent corporation) in proportion to their fair market value.

Current paragraph 95(2)(d) does not contain any rules to determine whether, for the purposes of the Act, the predecessor foreign corporations are considered to have disposed of their properties on the foreign merger.33 This question must be

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33 The deemed disposition rules in regulation 5907(9) apply only to a dissolution of a foreign affiliate, not to a foreign merger.
resolved in each foreign merger on a case-by-case basis by reference to the governing foreign law. This position is supported by the closing words of paragraph 95(2)(d.1), which provide, for greater certainty, that the deemed dispositions of property for the purposes of the Act on foreign mergers described in that paragraph do not affect the determination whether any property of a predecessor foreign corporation is disposed of on a foreign merger to which paragraph 95(2)(d.1) does not apply. If the assets of any predecessor corporation are considered to have been disposed of under the applicable foreign law, FAPI could result if those assets are not excluded property and there is an accrued gain. The application of current paragraph 95(2)(d) is summarized and illustrated in figure 6.

**Paragraph 95(2)(d.1): Broad Rollover in Limited Circumstances**

Paragraph 95(2)(d.1) provides broader non-recognition treatment for a foreign merger where the surplus entitlement of the Canadian taxpayer in respect of each predecessor foreign corporation is at least 90 percent; the taxpayer’s surplus entitlement in respect of the new foreign corporation is at least 90 percent; and, under the income tax law of the country in which the predecessor foreign corporations were resident before the merger, no gain or loss was recognized in respect of any capital property of a predecessor foreign corporation that became capital property of the new foreign corporation. In such circumstances, the general rule in paragraph 95(2)(d) will continue to apply to provide a rollover in respect of the shares of the predecessor foreign corporations held by the shareholder foreign affiliate(s) as capital property. In addition, paragraph 95(2)(d.1) will deem each capital property of a predecessor foreign corporation that became capital property of the new foreign corporation to have been disposed for proceeds equal to the cost amount of the property to the predecessor foreign corporation. The application of current paragraph 95(2)(d.1) is summarized and illustrated in figure 7.

**Proposed Paragraphs 95(2)(d) and (d.1)**

The proposed foreign affiliate rules contain substantial amendments to paragraph 95(2)(d), which, as proposed, will be applicable to foreign mergers that occur after February 27, 2004. The proposals also contain technical amendments to paragraph 95(2)(d.1) that were previously released in the December 20, 2002 draft legislation package; these amendments are proposed to be applicable to foreign mergers that occur after December 20, 2002.

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34 Many foreign jurisdictions recognize the concept of an absorptive merger, in which one or more corporations merge with and into another corporation, with the latter corporation surviving. Generally, a surviving corporation is not considered to have disposed of its assets on an absorptive merger.
FIGURE 6  Current Paragraph 95(2)(d)

Canco

FA 1

Rollover at ACB (or higher elected amount) for capital property shares

“Foreign merger”

FA 2

FA 3

Asset dispositions determined according to foreign law

Assets

Assets

FIGURE 7  Current Paragraph 95(2)(d.1)

Canco

>90%

CFA 1

Rollover at ACB (or higher elected amount) for capital property shares

>90%

>90%

“Foreign merger”

and foreign rollover for capital property

CFA 2

CFA 3

Rollover at cost for capital property assets

Assets

Assets
Retention of the Paragraph 95(2)(d.1) Broad Rollover

Proposed paragraph 95(2)(d.1) is amended in several respects. First, the non-recognition condition for its application is extended to require that, under the income tax law of the country in which the predecessor foreign corporations are resident, no income, gain, or loss is recognized in respect of any property of a predecessor corporation, not just capital property as is currently required. However, this change is linked to the extension of the rollover, which will apply to each property (not just capital property) of a predecessor corporation that becomes property of the new foreign corporation: each such property is deemed disposed of for proceeds equal to the cost amount of the property to the predecessor foreign corporation. In addition, revised paragraph 95(2)(d.1) imports the existing rule in paragraph 95(2)(d) that makes subsection 87(4) applicable to a shareholder of a predecessor foreign corporation where the shareholder is a foreign affiliate of a Canadian taxpayer. This change is a consequence of the amendment to paragraph 95(2)(d) that makes that paragraph inapplicable to a foreign merger to which paragraph 95(2)(d.1) applies.

As a result, the proposals continue and effectively extend the existing broad rollover in paragraph 95(2)(d.1) for foreign mergers where the 90 percent surplus entitlement and foreign non-recognition conditions are satisfied. In such circumstances, the shareholder affiliates will be deemed to dispose of their shares of the predecessor foreign corporations at their relevant cost base, and the predecessor foreign corporations will be deemed to dispose of all property, not just capital property, for proceeds equal to the cost amount.

Paragraph 95(2)(d): Rollover Restricted to Excluded Property

Proposed paragraph 95(2)(d) is amended in several significant ways. First, it will no longer apply to a foreign merger to which the more comprehensive rollover in paragraph 95(2)(d.1) applies, so that each of paragraphs 95(2)(d) and (d.1) will contain a complete code governing the foreign mergers to which they respectively apply. In addition, the circumstances in which paragraph 95(2)(d) applies are changed: the paragraph will require not that the shareholder of a predecessor foreign corporation be a foreign affiliate of a Canadian taxpayer, but rather that a predecessor foreign corporation itself be a foreign affiliate of a Canadian corporation, and that the new foreign corporation formed on the foreign merger be a foreign affiliate of the Canadian corporation. Thus, the revised paragraph 95(2)(d) rollover will be available only in respect of foreign affiliates of a corporation resident in Canada, not to foreign affiliate groups headed by a Canadian individual, trust, or partnership. Moreover, under the proposed paragraph a foreign merger of non-foreign affiliates owned by a foreign affiliate will not be covered.35

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35 Additional changes (though less significant to the theme of this article) include the following: (1) proposed subparagraph 95(2)(d)(iv) imports and expands the continuity rule in existing paragraph 95(2)(d.1), so that the new foreign corporation is deemed to be the same person as, and a continuation of, the particular predecessor foreign corporation for the purposes of the
Second, proposed subparagraph 95(2)(d)(i) introduces explicit rules to deal with the property of each predecessor foreign corporation, no longer relying on the relevant foreign law to determine whether the assets of the predecessor foreign corporations are disposed of for the purposes of the Act. Instead, each property of the new foreign corporation that was a property of a predecessor foreign corporation is deemed disposed of on the foreign merger to the new foreign corporation. If the property is excluded property, the proceeds of disposition to the predecessor foreign corporation are deemed to be equal to the relevant cost base. If the Canadian taxpayer claims a relevant cost base that exceeds the adjusted cost base, the predecessor foreign corporation will realize a gain and the taxable capital gain will be FAPI by virtue of item B of the FAPI definition in subsection 95(1). The forced rollover for excluded property is again an extension of the surplus suspension rules. However, if any property of a merging foreign affiliate is not excluded property, proposed subparagraph 95(2)(d)(i) will deem the proceeds of disposition to be the fair market value of the property immediately before the merger. If this results in a gain to the predecessor foreign corporation, the gain will give rise to FAPI. Subparagraph 95(2)(d)(ii) deems the cost of the property to the new foreign corporation to be equal to the deemed proceeds of disposition to the predecessor foreign corporation. If the property of the predecessor foreign affiliate consists of foreign affiliate shares that are not excluded property, any taxable capital gain realized will be FAPI, with no relief available under the deemed subsection 93(1) election pursuant to subsection 93(1.1), owing to the limitations in subsection 93(1.4).

Third, proposed subparagraph 95(2)(d)(iii) replaces the current rule that deems all shares of the predecessor foreign corporations held by the shareholder as capital property to be disposed of for proceeds equal to their adjusted cost base. Instead, if the shareholder of a predecessor foreign corporation is a “specified vendor” in respect of the Canadian corporation, the shareholder is deemed to dispose of each share of a predecessor foreign corporation that is excluded property for proceeds of disposition equal to the adjusted cost base of the shares, unless the Canadian corporation elects a higher amount (which would trigger a FAPI inclusion by virtue of item B of the FAPI definition in subsection 95(1)). The cost to the shareholder of each share of the new foreign corporation received in exchange for an excluded-property share of a predecessor foreign corporation is deemed to be equal to the deemed proceeds of disposition of the exchanged share, prorated by the fair market value of surplus and loss suspension rules in paragraphs 95(2)(c.1) to (c.6), (f.3) to (f.93), and (h) to (h.5); (2) subparagraph 95(2)(d)(v) deems the taxation year of each predecessor foreign corporation to end immediately before the foreign merger; and (3) subparagraph 95(2)(d)(vi) introduces a new benefit conferral rule applicable if the fair market value of a shareholder's shares of the new foreign corporation is less than the fair market value of the shares of the predecessor foreign corporation, and the excess can reasonably be considered to be a benefit that the shareholder desired to have conferred on another shareholder of the foreign corporation.
all shares of the new foreign corporation received on the merger. A “specified vendor” does not appear to be specifically defined for these purposes, but according to the definition set out in proposed subsection 95(3.2), a “specified vendor” in respect of a corporation resident in Canada means a foreign affiliate of the corporation or of a partnership of which the corporation is a member, and certain other partnerships. The forced rollover for excluded-property shares of a predecessor foreign corporation disposed of by a specified vendor is the analogue to the new surplus suspension rules in proposed paragraphs 95(2)(c.1) to (c.6) and (f.3) to (f.9), which, by virtue of subparagraphs 95(2)(c.1)(iv) and 95(2)(f.6)(i), do not apply to foreign mergers governed by paragraph 95(2)(d).

Proposed paragraph 95(2)(d) does not expressly deal with the treatment of shares of a predecessor foreign corporation that are not excluded property, nor do the amendments to the regulations (in particular, regulations 5907(9) and (9.1)). This is in contrast to the current provision, which expressly imports the rollover in subsection 87(4) for all predecessor foreign corporation shares held as capital property. Presumably, then, the more general provisions of subsection 87(4), as made applicable to foreign mergers by subsection 87(8), are intended to apply. As a result, the non-excluded-property shares of a predecessor foreign affiliate will be deemed disposed of for proceeds equal to their adjusted cost base, provided that those shares were held as capital property. The application of proposed paragraph 95(2)(d) is summarized and illustrated in figure 8.

Implications of Proposed Paragraph 95(2)(d)

The proposed revisions to the foreign merger rollovers in paragraphs 95(2)(d) and (d.1) present problems similar to those discussed above in the context of lower-tier foreign affiliate liquidations. In particular, the more specific rollover in paragraph 95(2)(d.1) has been retained, and in fact broadened, by virtue of the extension of the rule that deems a disposition of the predecessor foreign affiliate’s capital property at cost, so that the deemed disposition at cost will apply to all property of the

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36 Proposed clause 95(2)(d)(iii)(B) refers only to the acquisition of shares of the new foreign corporation. In a triangular merger, the acquired shares would be shares of the foreign parent corporation. Presumably this provision will be revised in the next version of the draft legislation to deal appropriately with triangular foreign mergers.

37 The definitions in proposed subsection 95(3.2) are stated to apply for the purposes of specific provisions, which do not include paragraphs 95(2)(d) and (d.1). Presumably this drafting inconsistency will be remedied in the next version of the draft legislation.

38 Subsection 87(8) makes subsection 87(4) applicable to foreign mergers, with contextual modifications, but is expressed as having that effect “subject to subsection 95(2).” It appears that since proposed paragraph 95(2)(d) is silent with respect to the proceeds of disposition of non-excluded-property shares of a predecessor foreign corporation, subsection 87(8) should fill the void. However, clarifying amendments would be useful in the next version of the draft legislation.
predecessor foreign affiliate. Therefore, if paragraph 95(2)(d.1) applies to the foreign merger, the merger will occur on a complete rollover basis, with no gain (and no FAPI) being realized by any predecessor corporation on the deemed disposition of its assets, and no gain (and no FAPI) being realized by any shareholder on the deemed disposition of the shares of the predecessor foreign corporations pursuant to subsection 87(4). The problem is that the complete rollover of paragraph 95(2)(d.1) applies only in very specific circumstances—namely, where the Canadian taxpayer has a 90 percent surplus entitlement in respect of each predecessor foreign corporation and the new foreign corporation, and the foreign merger is accorded full non-recognition treatment in the relevant foreign jurisdiction. If these strict conditions for the complete rollover are not satisfied, the taxpayer must rely on the rollover provisions of paragraph 95(2)(d), which are proposed to be revised in several ways adverse to the taxpayer.

Most significantly, the new rules in proposed paragraph 95(2)(d) that provide for a deemed disposition of all property of a predecessor foreign corporation will result in a rollover only for excluded property. Non-excluded property of a predecessor foreign corporation, including non-excluded-property foreign affiliate shares, will be deemed disposed of for fair market value proceeds, triggering FAPI to the extent of any gain; the gain cannot be reduced by a deemed subsection 93(1) election. This is an adverse change for many foreign mergers that are treated under local law as absorptive mergers, in which the surviving corporation is not considered under local corporate law to have disposed of its property. Current
paragraph 95(2)(d) does not apply to deem a fair market value disposition of non-excluded property in such circumstances. Moreover, the current rule that provides a rollover for all shares of any predecessor foreign corporation, by virtue of the importation of subsection 87(4) with contextual modifications, is being replaced with a rule that provides a rollover only for shares of a predecessor foreign corporation that are excluded property. No express rule is provided for non-excluded-property predecessor foreign corporation shares; this suggests that subsection 87(4) will result in a disposition of those shares on a rollover basis only if they are held as capital property.

Furthermore, the narrowed paragraph 95(2)(d) rollover will be available only to Canadian corporations, not to individuals, trusts, or partnerships that hold foreign affiliate groups. Non-corporate taxpayers will have access only to the more complete rollover in paragraph 95(2)(d.1), and then only if the strict conditions for that provision are satisfied.

As with the proposed restrictions to the existing rollovers in subsection 88(3) and paragraph 95(2)(e), the narrowing of the paragraph 95(2)(d) rollover to cover only excluded property held by the predecessor foreign affiliates and excluded-property shares of the predecessor foreign affiliates will further constrain Canadian taxpayers’ flexibility in undertaking appropriate reorganizations of their foreign holding structures without triggering Canadian tax. In the many circumstances where the strict conditions of paragraph 95(2)(d.1) are not met, Canadian taxpayers will face the prospect of incurring Canadian tax on a foreign merger. A broad range of ownership positions do not meet the 90 percent surplus entitlement threshold but nevertheless retain controlled foreign affiliate status for the predecessor foreign corporations and their shareholders, so that any FAPI triggered in respect of any gains deemed realized on non-excluded property will give rise to Canadian tax. The cost of obtaining comfort on the excluded-property status of all of the relevant assets and the shares of the predecessor foreign corporations, the risk of the excluded-property determination being challenged by the CRA or found to be incorrect, and the cost of Canadian taxes on FAPI income triggered on the foreign merger may discourage Canadian taxpayers from undertaking foreign mergers that, for other valid commercial reasons, would be completed but for the absence of certain Canadian rollover treatment.

**Modifications Under Consideration by Finance**

At the May 9, 2005 IFA seminar, Finance indicated that it is considering extending the application of the broad paragraph 95(2)(d.1) rollover by eliminating both the 90 percent surplus entitlement requirement and the “no foreign tax recognition” requirement. This change, if adopted, would constitute a fundamental rethinking of the scope of foreign merger rollover relief and would fully address the concerns discussed above. Indeed, it appears that the proposal under consideration is the elimination of the more limited paragraph 95(2)(d) rollover such that the broader relief in paragraph 95(2)(d.1) would apply to all foreign mergers of lower-tier foreign affiliates. In addition, while existing and proposed paragraphs 95(2)(d.1) both provide
for a mandatory rollover of property of the predecessor foreign affiliates that becomes property of the new foreign corporation on the merger, Finance is considering allowing the Canadian taxpayer to elect a disposition at the relevant cost base, such that any elected gain recognized would give rise to FAPI.

IN SUPPORT OF BROAD FOREIGN AFFILIATE SHARE EXCHANGE ROLLOVERS

When the February 27, 2004 proposals to narrow the existing foreign affiliate reorganization rollovers in subsection 88(3) and paragraphs 95(2)(d) and (e) were first released, a number of interested practitioners and taxpayers expressed their concerns in representations to Finance. Several tax policy arguments have been made in support of the position that the proposed limitations to the foreign affiliate reorganization rollovers are not appropriate, to the extent that the proposals will deny rollover treatment for non-excluded-property foreign affiliate shares disposed of on an intragroup reorganization. It is apparent that Finance is sympathetic to these policy arguments, as evidenced in particular by the comments at the May 9, 2005 IFA seminar, but it remains to be seen whether the modifications to the February 27, 2004 proposals currently under consideration will ultimately be reflected in revised draft legislation that largely restores the existing FAPI rollovers for foreign affiliate liquidations and mergers. Accordingly, in support of a coherent tax policy framework for the rules in the Act governing reorganizations of foreign affiliates, the principal arguments for broad rollover relief from the FAPI rules are summarized below.

Triggering FAPI on Share Exchanges: Inconsistency with the Realization Principle

Stated succinctly, the “realization principle” of taxation is that only “realized” gains are taxable as income—that is, tax is imposed only on actual gains, not on deferred or potential or anticipated gains such as the appreciation in value of an asset.39 The realization principle underlies most of the domestic rollovers in the Act; various share-for-share exchange transactions are accorded rollover treatment on the theory that an exchange of shares does not result in a realization of a taxpayer’s investment

in the disposed shares. The premise of these rollovers is that the taxpayer’s investment is not realized but instead is continued in the form of new shares. Examples include the automatic share-for-share exchange rollover in subsection 85.1(1), the share capital reorganization rollover in subsection 86(1), the domestic amalgamation rollover in subsection 87(4), the foreign affiliate share-for-share exchange rollover in subsection 85.1(3), and the foreign merger rollover in subsection 87(8). Indeed, the trend in recent years has been to expand the scope of the rollover relief in share-for-share exchanges, as evidenced by the enactment in 2001 of the foreign share-for-share exchange rollover in subsection 85.1(5) and the foreign spinoff rollover in subsection 86.1(1), and by the announcement in the October 18, 2000 federal budget update (as reiterated in the February 18, 2003, March 23, 2004, and February 23, 2005 federal budgets) of Finance’s intention to legislate a new cross-border share-for-share exchange rollover.

The theoretical underpinnings of the realization principle of taxation are well rehearsed in the tax literature. The principal arguments justifying non-recognition of “like-kind” exchanges, including share-for-share exchanges such as those currently accorded rollover treatment in the Act, can be summarized as follows:

1. **Continuity of investment.** After a share-for-share exchange, the taxpayer’s economic position is very close to what it was before the exchange. Before the exchange, the taxpayer held a share investment in certain underlying assets; after the exchange, the taxpayer continues to own a share investment (albeit an investment in different shares) that participates economically in a group of assets that generally includes the same underlying assets that contributed to the value of the share investment held before the exchange. When there is such continuity of investment, the taxpayer cannot be said to have realized the investment and accordingly should not be taxed on accrued gains.

2. **Illiquidity of disposition proceeds.** On a share-for-share exchange, the taxpayer does not convert the initial share investment into a liquid asset such as cash. Rather, the investment is retained in an illiquid form—namely, shares. The taxpayer’s ability to pay tax is not enhanced by the share-for-share exchange, and accordingly the exchange should not be considered a realization of the investment that gives rise to a tax liability on accrued gains.

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3. **Efficiency considerations—avoiding the “lock-in” effect.** If a share-for-share exchange is treated as a realization event that gives rise to tax on accrued gains, taxpayers may avoid or defer the exchange transaction in order to avoid or defer the tax. If the benefits of completing the exchange transaction do not exceed the cost of accelerating the tax liability in respect of the accrued gain, the taxpayer will be faced with an artificial tax disincentive to complete the exchange transaction and may be locked in to holding the investment in an undesirable or inefficient form when non-tax reasons dictate that the share exchange should occur.

   The realization principle suggests that insofar as a top-tier foreign affiliate liquidation, a lower-tier foreign affiliate liquidation, or a lower-tier foreign affiliate merger results in a disposition of foreign affiliate shares in exchange for other foreign affiliate shares, the exchange should be treated as a non-recognition event for Canadian tax purposes. The realization principle does not depend on whether the exchanged foreign affiliate shares are excluded property. What matters, according to the realization principle, is that after the share exchange the taxpayer continues to own an illiquid share investment that represents an economic interest in similar underlying assets.

   In the domestic context, the availability of the broad range of share-for-share exchange rollovers does not depend on the “active business” or “property income” status of the assets held by the corporation whose shares are subject to the exchange. Before the February 27, 2004 foreign affiliate proposals, the excluded-property status of the foreign affiliate shares exchanged on the foreign affiliate liquidation and merger transactions that are the subject of this article did not affect the availability of rollover treatment, and excluded-property status continues to be irrelevant for the foreign affiliate share-for-share exchange rollover in paragraph 95(2)(c). Before the proposals, all foreign affiliate shares distributed on the liquidation of a top-tier foreign affiliate were disposed of on a rollover basis; all foreign affiliate shares distributed on the liquidation of a lower-tier foreign affiliate were disposed of on a rollover basis; and all capital property shares of a predecessor foreign affiliate exchanged on a foreign merger were disposed of on a rollover basis. If the February 27, 2004 proposals are not modified, subsection 88(3) and paragraphs 95(2)(e) and (d) will eliminate this rollover treatment for foreign affiliate shares that are not excluded property.

   It is true that the excluded-property status of the foreign affiliate shares disposed of in these foreign affiliate reorganizations is relevant when Finance intends to force rollover treatment to avoid surplus creation, as is evident from the new surplus suspension rules. But by using the non-excluded-property status of the foreign affiliate shares as the basis for denying rollover treatment on these share-for-share exchange transactions, Finance has departed from the realization principle, which has consistently underpinned the existing domestic and foreign affiliate share-for-share exchange rollovers. The test for rollover treatment should be whether there has been a realization of the taxpayer’s investment—that is, the nature of the property received (foreign affiliate shares or boot), not its excluded-property status. If the taxpayer exchanges foreign affiliate shares for other foreign affiliate shares on a liquidation or merger, non-recognition treatment should continue to be available.
regardless of the excluded-property status of the exchanged foreign affiliate shares. It is not necessary to deny rollover treatment for non-excluded-property foreign affiliate shares in order to force rollover treatment for excluded-property dispositions and achieve Finance’s surplus suspension objectives. Surplus suspension for excluded-property dispositions can coexist with continued rollover treatment for non-excluded-property foreign affiliate share exchanges.

Restrictions to Rollovers: Inconsistency with the Scheme of the Foreign Affiliate Rules

“One-Sided” Non-Recognition

There is an inherent inconsistency between the proposed surplus suspension and loss suspension rules and the proposed restrictions to the foreign affiliate rollover provisions discussed in this article. For example, the surplus suspension rules in proposed paragraphs 95(2)(c.1) to (c.6) and (f.3) to (f.9) deem all excluded property that is disposed of by a specified vendor to a specified purchaser (that is, on an intragroup transaction) to be disposed of on a forced rollover basis if there is an accrued gain on the property. This rule will defer the creation of earnings (and surplus) on intragroup transfers of excluded property until the property is disposed of outside the group on a triggering disposition. However, if the intragroup disposition of the excluded property gives rise to a loss, proposed paragraphs 95(2)(c.1) to (c.6) and (f.3) to (f.9) will not apply, and the loss will be realized at the time of the disposition to erode the appropriate surplus balances. On the other hand, if the property disposed of for a loss on an intragroup transfer is not excluded property (or depreciable property or eligible capital property), the loss suspension rules in proposed paragraphs 95(2)(h) to (h.5) will defer the realization of the FAPI loss until there is a triggering disposition outside the group. But there is no similar rule that defers the recognition of the FAPI gain realized on non-excluded property disposed of on an intragroup transfer. Although the fairness of the proposed surplus and loss suspension rules may be questioned, at least the rules do not have the effect of creating FAPI where none would be realized under the current rules.

In contrast, the approach taken in the February 27, 2004 draft legislation with respect to the foreign affiliate reorganization rollovers in subsection 88(3) and paragraphs 95(2)(d) and (e) (and (e.3) to (e.5)) is to deem all excluded-property dispositions to occur on a forced rollover basis (regardless of whether there is an accrued gain or loss on the excluded property) and to deem all non-excluded-property dispositions to occur at fair market value. If the non-excluded property is disposed of at a loss, the loss suspension rules in proposed paragraphs 95(2)(h) to (h.5) will apply to defer the FAPI loss; but if the non-excluded property is disposed of at a gain, the FAPI gain is realized at the time of disposition (with no deferral). This “one-way” treatment is difficult to justify because the effect is to trigger FAPI, and Canadian tax, as a result of intragroup reorganization transactions that currently do not give rise to FAPI (at least in respect of non-excluded-property foreign affiliate shares). One-sided amendments (the surplus and loss suspension rules) that suspend certain potentially beneficial tax consequences of internal transactions may
be justifiable, but one-sided amendments (those that curtail the foreign affiliate share reorganization rollovers) that result in the realization of FAPI (and Canadian tax) on intragroup reorganizations that are currently non-taxable, and that suspend any potentially offsetting FAPI losses, are arguably not appropriate.

**FAPI Provisions as Anti-Avoidance Rules**

The FAPI rules may be viewed as a set of anti-avoidance provisions layered onto the Canadian foreign affiliate rules in the Act. As noted earlier, their fundamental purpose and effect is to promote capital export neutrality in the Canadian tax system. The FAPI rules discourage Canadian-resident taxpayers from earning passive income through a controlled foreign affiliate that itself is not subject to Canadian tax by imposing current tax on such income and thereby making the taxpayer indifferent with respect to whether the passive income is earned directly in Canada or indirectly offshore. The FAPI rules were never intended to generate substantial Canadian tax revenue from foreign-source income; arguably their main effect has been prophylactic, by keeping within the Canadian tax net passive income that would otherwise be earned offshore so as to benefit from the deferral of Canadian tax.

The February 27, 2004 proposed restrictions to the existing foreign affiliate share reorganization rollovers in subsection 88(3) and paragraphs 95(2)(d) and (e) arguably deviate from the anti-avoidance nature of the FAPI rules, since their effect will be to make common intragroup foreign affiliate reorganization transactions taxable in Canada. In most cases, foreign affiliate reorganizations are motivated by foreign commercial or tax considerations that are completely unrelated to the Canadian tax system. To the extent that foreign considerations dictate that the foreign affiliate reorganization should proceed despite the adverse Canadian tax consequences that may now result under the amended and restricted rollover rules, the new rules appear to have more of a revenue-generating or tax-charging character, inconsistent with the anti-avoidance objectives they were originally designed to achieve.

**Adverse Competitiveness Consequences for Canadian Multinationals**

It is widely acknowledged that an express purpose of the exemption system for exempt surplus dividends is to enhance the competitiveness of Canadian-based multinationals that operate in foreign jurisdictions. The exempt surplus system promotes capital import neutrality by allowing profits earned by Canadian-resident corporations through foreign affiliates incorporated in and carrying on active

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42 See Angelo Nikolakakis, “Exempt Surplus: What’s the Problem? A Reply to Brian Arnold” (2002) vol. 50, no. 4 Canadian Tax Journal 1354-77, for a review of the historical statements of purpose with respect to the “competitiveness” features of the exemption system.
business in designated treaty countries to be repatriated to Canada without being subject to Canadian tax. Such active business profits are taxed in the relevant foreign jurisdiction; by not imposing further Canadian tax on the same profits, the exempt surplus system allows Canadian-resident taxpayers to compete on a level playing field, from a tax perspective, with local businesses that also would be subject to the same tax burden in the foreign jurisdiction. However, it is inconsistent with this scheme for the Act to make common reorganization transactions taxable in Canada when in many cases they would not be taxable in the foreign jurisdiction. When foreign non-recognition treatment is accorded to a reorganization transaction, the imposition of Canadian tax on the transaction will subject the taxpayer to costs that are not borne by local competitors. The proposed restrictions to the existing foreign affiliate share exchange rollovers in the Act risk distorting the behaviour of Canadian taxpayers, who may now face a Canadian tax disincentive to undertake a transaction that competitors from other jurisdictions do not face.

The February 27, 2004 amendments to the foreign affiliate share reorganization rollovers will also affect the competitiveness of Canadian-based multinationals by potentially increasing the costs of compliance. The proposed rules generally provide for a forced rollover for excluded property and for realization at fair market value for non-excluded property. This means that the excluded-property status of every single asset of the liquidating or merging affiliate will have to be determined; depending on the outcome, radically different tax consequences will follow.

The proposed amendments implicitly assume that the excluded-property status of property in a foreign affiliate is easy to determine. In practice, however, excluded-property determinations are often challenging and uncertain. The excluded-property status of shares of a foreign affiliate depends on whether at least 90 percent of the affiliate’s property is itself excluded property; thus, an examination must be made of all of the assets and activities of every lower-tier subsidiary. If a relatively small (but greater than 10 percent by value) property in a bottom-tier foreign affiliate cannot clearly be shown to meet the excluded-property conditions, the taint will “tier up” and potentially disqualify the shares of higher-tier foreign affiliates. Interpretive ambiguities will arise if the assets being tested are surplus cash balances, cross-shareholdings of other corporations, and intercompany advances that may not strictly meet the conditions for deemed active business treatment in subparagraph 95(2)(a)(ii), or if the activities of the relevant foreign affiliate are potentially caught by the “investment business” definition in subsection 95(1). As a result, it can often be very difficult to reach conclusive determinations of the excluded-property status of any particular asset in a foreign affiliate. Large corporate groups may have to devote significant internal resources or incur significant costs for external advisers in order to perform an excluded-property analysis of all of their foreign assets. Although some of these costs are currently incurred under the existing FAPI rules, they are not usually necessary in the context of a foreign affiliate share reorganization that is accorded rollover treatment under the existing rules. The proposed rules increase the circumstances in which excluded-property determinations will be required. Canadian-based multinationals are likely to incur
substantial compliance costs and will undoubtedly reach uncertain conclusions in many cases because of incomplete or difficult-to-obtain foreign information. For foreign affiliates of Canadian-based parent companies, the result is likely to be higher costs and more uncertainty than their local competitors will experience.

Inconsistency with Domestic Share Exchange Rollovers

Why should foreign affiliate rollovers be permitted in circumstances where domestic rollovers are not? Finance’s comments at the May 9, 2005 IFA seminar with respect to possible modifications to the February 27, 2004 proposals suggest that conformity with the domestic rollover rules may now be the guiding principle. For example, Finance is considering allowing the broad rollover relief for foreign affiliate liquidations to continue to be available only if the taxpayer meets a 90 percent or greater fair market value ownership test (in the case of lower-tier foreign affiliate liquidations) and a “90 percent of votes and value” test (in the case of top-tier foreign affiliate liquidations, as described in the August 16, 2005 Finance comfort letters).

These tests are analogous to the 90 percent ownership requirement for the domestic liquidation rollover in subsection 88(1). Finance is also considering extending foreign affiliate merger relief to all lower-tier foreign mergers, in keeping with the broad domestic merger rollover rules in section 87. It is apparent that there is inconsistency between both the current versions and the February 27, 2004 proposed versions of the foreign affiliate rollover rules that are the subject of this article and the corresponding domestic rollover rules. In this section, I will briefly consider the possible merits and implications of this “conformity” argument.

First, the domestic amalgamation rollover provisions in section 87 are very broad. Subsection 87(4) provides a complete rollover for shares of a predecessor corporation held as capital property that are exchanged for shares of the amalgamated corporation, and subsection 87(2) provides a rollover for all types of property held by a predecessor corporation. No ownership threshold is required. In the foreign affiliate context, existing paragraph 95(2)(d.1) provides an analogous complete rollover for shares of a predecessor foreign corporation and property held by a predecessor foreign corporation, except that paragraph 95(2)(d.1) applies only when the 90 percent surplus entitlement and foreign non-recognition conditions are satisfied. If these strict conditions are not met, the rollover relief is limited to that provided by paragraph 95(2)(d), which as proposed will not extend to non-excluded property held by the predecessor foreign corporations. In the case of foreign mergers, therefore, the conformity argument suggests that the proposed paragraph 95(2)(d.1) rollover should be broadened so that it applies to any foreign merger, not just to foreign mergers that meet the strict 90 percent surplus entitlement and foreign non-recognition conditions. Such a broadening of paragraph 95(2)(d.1) would eliminate the need for the less comprehensive rollover in paragraph 95(2)(d). As noted above, this is precisely the modification that is now under consideration by Finance.

On the other hand, the existing rollover rules applicable to domestic liquidations are much narrower, in the sense that the non-recognition provisions of subsection 88(1) apply only when the shareholder of the liquidating Canadian corporation is another Canadian corporation that owns at least 90 percent of the shares of each
class of the dissolving corporation. Any domestic corporate liquidation that does not meet this 90 percent corporate ownership threshold will occur on a fully taxable basis under subsections 88(2) and 69(5). In this regard, the foreign affiliate liquidation rollover in both existing and proposed paragraph 95(2)(e.1) offers analogous non-recognition treatment in analogous ownership circumstances—although, in addition to the 90 percent surplus entitlement threshold, the foreign affiliate liquidation rollover further requires that the liquidation occur on a complete rollover basis under the applicable foreign law. If conformity with the domestic corporate dissolution rollover is the relevant standard, then the foreign rollover requirement should be eliminated from paragraph 95(2)(e.1), leaving only the analogous 90 percent ownership test. Again, this is precisely the modification now under consideration by Finance. Moreover, if conformity with the domestic rule is the standard, then both the current and the proposed paragraph 95(2)(e) foreign affiliate liquidation rollovers should be considered over-broad, since they provide a rollover (proposed in the February 27, 2004 draft legislation to be limited to excluded property held by the dissolving foreign affiliate) even when the 90 percent surplus entitlement test may not be satisfied. Of course, in the case of proposed paragraph 95(2)(e), this “over-broad” result is deliberate, since the intention is to force a rollover for all excluded property disposed of on the liquidation in order to achieve the surplus suspension objectives of the proposed amendments.

The imperfect conformity is even more starkly evident in the case of the February 27, 2004 version of proposed subsection 88(3), where the rollover is limited to excluded property held by the dissolving foreign affiliate regardless of the ownership position of the Canadian taxpayer in the dissolving foreign affiliate. On this basis, the rollover in proposed subsection 88(3) should be considered insufficiently broad in comparison with the domestic corporate dissolution rollover, which provides complete non-recognition treatment when the 90 percent ownership test is satisfied. On the other hand, subsection 88(3) (both current and proposed) could be considered over-broad because it provides (limited) rollover relief even in circumstances where the 90 percent test is not satisfied and the domestic rule would provide for a fully taxable liquidation. If conformity with the domestic rollover is the relevant standard, subsection 88(3) should at least offer a complete rollover for all property disposed of by the dissolving foreign affiliate to the Canadian taxpayer when the Canadian taxpayer has at least a 90 percent ownership interest in respect of the dissolving foreign affiliate. Once again, this is essentially the modification now under consideration by Finance.

However, the foregoing discussion illustrates that conformity with the domestic rollover rules is not the relevant principle underlying the existing foreign affiliate rollover rules: existing paragraph 95(2)(d) is too narrow, existing paragraph 95(2)(e) is too broad, and existing subsection 88(3) is both too narrow and too broad. Instead, the relevant principle arguably has been, and should continue to be, the realization principle: where a foreign affiliate share exchange reorganization is undertaken in which a shareholder disposes of a share of a foreign affiliate and receives as consideration shares of a foreign affiliate, the transaction should be accorded non-recognition treatment because the shareholder has not realized its investment in a
manner or degree sufficient to justify the imposition of tax. Consistent with this principle, the original drafters of the foreign affiliate reorganization rules provided for rollover treatment for all foreign affiliate shares distributed on liquidations under subsection 88(3) and paragraph 95(2)(e), and allowed rollover treatment under paragraph 95(2)(d) for property of predecessor foreign corporations that under the relevant foreign law is not disposed of on a foreign merger. Conformity with the domestic rollover rules may not have been an overriding concern to the original drafters because the FAPI rules are anti-avoidance provisions and not tax-charging rules: for example, it may have been considered acceptable to offer non-recognition treatment for foreign affiliate share exchanges in subsection 88(3) and paragraph 95(2)(e) where such non-recognition treatment would be denied domestically (that is, where the 90 percent ownership test is not satisfied), because to override the realization principle and treat a foreign affiliate share exchange in a foreign affiliate liquidation as a taxable transaction giving rise to Canadian tax would effectively use the anti-avoidance FAPI rules as tax-charging rules, which is not their intended purpose. That is to say, the FAPI rules have an anti-avoidance purpose in promoting capital export neutrality, not a revenue-generating purpose as in the case of the domestic gains recognition rules, and this may justify broader relief from current Canadian tax on share exchange transactions involving foreign affiliate shares in circumstances (less than 90 percent ownership) where the analogous domestic rollover rule would not apply.

In any event, Finance now appears to be guided by the principle of conformity with the domestic share exchange rollovers, based on the modifications to the February 27, 2004 foreign affiliate proposals that are now apparently being considered. Finance is to be applauded for stepping back from the more egregious aspects of the February 27, 2004 FAPI rollover curtailment; however, the basis on which it now proposes to amend the rules (namely, conformity with domestic rollovers) is arguably not the principle with the most solid tax policy justification. The realization principle, not the principle of conformity with domestic share exchange rollovers, should govern the design of Canada’s foreign affiliate reorganization rollovers.

**A RECOMMENDED APPROACH**

The February 27, 2004 foreign affiliate proposals, if enacted as proposed, will eliminate the existing share-for-share exchange rollovers in subsection 88(3) and paragraphs 95(2)(d) and (e) for dispositions of foreign affiliate shares that are not excluded property. This will inhibit top-tier foreign affiliate liquidations, lower-tier foreign affiliate mergers, and lower-tier foreign affiliate liquidations in cases where the Canadian taxpayer cannot be certain that the foreign affiliate shares disposed of are excluded property. Although it is laudable that the existing rollovers in paragraphs 95(2)(d.1) and (e.1) are being broadened, if the paragraphs are enacted as proposed in the February 27, 2004 draft legislation they will continue to apply only in very strict circumstances where the 90 percent surplus entitlement and foreign non-recognition conditions are satisfied. In many other circumstances, foreign affiliate reorganizations involving dispositions of foreign affiliate shares will give rise to FAPI or a risk of FAPI if the excluded-property status of the shares is uncertain.
I submit that the proposed restrictions to the existing foreign affiliate reorganization rollovers are not consistent with the realization principle that underlies the domestic and foreign affiliate share-for-share exchange rollovers in the Act. There is no sound policy basis for the proposed rules to use the excluded-property status of the disposed foreign affiliate shares as the factor determining whether rollover treatment should be accorded to a foreign affiliate liquidation or merger. The excluded-property status of the disposed foreign affiliate shares is clearly relevant to the circumstances in which non-recognition should be forced in order to achieve the surplus suspension objectives of the new rules, but it is not the appropriate test for denying a rollover. A rollover should be denied only if and to the extent that the property received in exchange for a disposition of a foreign affiliate share is non-share consideration, or boot.

To the extent that the shareholder receives shares of a foreign affiliate in exchange, however, a rollover should be available, as is the case in numerous domestic rollovers and in the existing foreign affiliate reorganization rollovers. The proposed narrowing of the foreign affiliate liquidation and merger share exchange rollovers is not appropriate from a policy perspective because it effectively uses the FAPI rules, which were designed to achieve anti-avoidance objectives, as tax-charging or revenue-generating rules. The surplus suspension objectives of Finance do not require by corollary that a rollover be denied if the foreign affiliate shares disposed of on a liquidation or merger are not excluded property. Surplus suspension on intra-group excluded-property dispositions is not incompatible with continued rollover treatment for foreign affiliate shares that are disposed of on a foreign affiliate liquidation or merger. Accordingly, the existing foreign affiliate share exchange rollovers in subsection 88(3) and paragraphs 95(2)(d) and (e) should be preserved for both excluded-property and non-excluded-property foreign affiliate share dispositions.

Finance has indicated that it is sympathetic to these submissions. The modifications to the original February 27, 2004 proposals that are now under consideration will, if adopted, go very far toward restoring FAPI rollover treatment in appropriate circumstances and bringing the FAPI rollovers into substantial conformity with the domestic rollovers for corporate liquidations and mergers. In that respect, I support these modifications. Although I have argued that the realization principle (and not conformity with domestic rollovers) should be the appropriate standard, as a practical matter the modifications under consideration by Finance—in particular, the extended application of paragraphs 95(2)(d.1) and (e.1) and the (albeit limited) availability of an elective rollover in subsection 88(3)—should achieve the same desired comprehensive rollover result for all foreign mergers and for foreign affiliate liquidations in which the Canadian taxpayer has a 90 percent ownership interest.

Yet the realization principle requires the Act to go further for foreign affiliate liquidations that do not meet the 90 percent ownership interest test. As in current subsection 88(3) and paragraph 95(2)(e), dispositions of foreign affiliate shares, whether or not they are excluded property, should occur on a rollover basis when a foreign affiliate is liquidated, even if the Canadian parent has less than a 90 percent ownership interest. Why should the liquidation rollovers in the FAPI rules be more
generous than the domestic corporate liquidation rollover in subsection 88(1)? In the FAPI context, there is no part I corporate income tax leakage, which is the concern of subsection 88(1). The purpose of the FAPI rules is to promote capital export neutrality, not to raise revenue. Does a broad foreign affiliate liquidation rollover create an incentive for a Canadian taxpayer to shift passive income sources to a controlled foreign affiliate? Arguably not. When the realization principle and the conformity principle conflict (for top-tier and lower-tier foreign affiliate liquidations when the 90 percent ownership interest test is not satisfied), the conformity principle should yield to the realization principle and a share exchange rollover should continue to be provided.

In the end, the foreign affiliate liquidation and merger rollovers recommended in this article would build on the modifications under consideration by Finance; they would be guided by both the realization principle and the principle of conformity with domestic rollovers in the following manner:

- The comprehensive rollover in paragraph 95(2)(d.1) for all assets of the merging affiliates and for the shares of all merging affiliates would be extended to all foreign mergers (as is currently under consideration by Finance) by eliminating the 90 percent surplus entitlement and foreign non-recognition requirements. (This would eliminate the need for paragraph 95(2)(d).)
- The comprehensive rollover in paragraph 95(2)(e.1) for all assets of the liquidating foreign affiliate, and for the shares of the liquidating foreign affiliate, would be available in all cases where the 90 percent ownership interest test is satisfied (as is currently under consideration by Finance) by eliminating the foreign non-recognition requirement.
- The more limited rollover in paragraph 95(2)(e) for all foreign affiliate shares (whether or not they are excluded property) distributed on the liquidation would be restored for any lower-tier foreign affiliate liquidation that does not meet the 90 percent ownership interest requirement of paragraph 95(2)(e.1).
- The subsection 88(3) rollover for assets distributed on the liquidation of a top-tier foreign affiliate would be extended to all such distributed property (share and non-share assets, whether or not they are excluded property) if the 90 percent ownership interest test is satisfied (as is currently under consideration by Finance).
- The more limited rollover in subsection 88(3) for all foreign affiliate shares (whether or not they are excluded property) distributed on the liquidation would be restored for any top-tier foreign affiliate liquidation that does not meet the 90 percent ownership interest requirement.

If adopted, these recommendations would, it is hoped, make the foreign affiliate liquidation and merger rollovers consistent with their domestic counterparts, and at the same time remain true to the overriding realization principle that has always been reflected in the share exchange rollover provisions of the Act.