Mr. Flaherty, Tear Down These Rules

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Mr. James Flaherty
Department of Finance
Ottawa, Canada

Dear Mr. Flaherty:

Re: FIE Proposals

I am writing to you from Maui, where I spend a good chunk of the summer. I work in the mornings and then take advantage of the six hour time difference from Toronto to spend most afternoons windsurfing. This regimen has a way of putting things in perspective, including – believe it or not – our country's international tax policy. Actually, that's why I'm writing. I would like to invite you come to my windsurfing beach - maybe you might pick up some pointers.

I'm sure you're wondering, what in the world does windsurfing have to do with international tax policy? You see, Mr. Flaherty (may I call you Jim?) most people on my windsurfing beach are barely aware that Canada exists. There are only a few of us here, dwarfed by legions of Japanese, Europeans, and of course US'rs. Worse still, I'm in constant peril of being bumped into by one of the Japanese windsurfers – they're very competitive and aggressive. So here's my point: Just like on my windsurfing beach, international business can be tough competition for Canadian businesspeople - they need all the help they can get! A smallish country like Canada should be structuring its international tax laws to encourage Canadian competition abroad.

Jim, I'd like to bend your ear about one pretty flagrant example: the FIE (foreign investment entity) proposals in Bill C-33, which passed through the House of Commons last month with only minor changes. My impression is that not many tax advisors have had an opportunity to go into the proposals in detail; so you probably haven't received many letters on them. But I have seen enough of them to realize that they are a morass of complexity that may seriously hamper international investment by Canadian businesses.

After numerous rounds of revisions, the FIE proposals are top-heavy with complexity often bordering on the nonsensical. Here's an irony: a major rationale for the rules was to deal with offshore mutual funds and the like. As the original legislation featured a hard-to-enforce test as to whether there was a tax-avoidance motivation for making the investment, the complex new rules were introduced. Several rounds of revisions later we found that the similar motivation tests were reinstated for many or most of these sorts of investments – along with page after page of fine print, having nothing to do with offshore funds and everything to do with legitimate international investment.

The rules are structured so that unless an investment in a foreign entity fits specifically into an exemption, it's a FIE, with the typical result that there is a deemed income based on prescribed interest rates as applied to the "designated cost" of the FIE. While a major exemption is available for controlled foreign affiliates**[1]** (in most cases) anything else - most "co-ventures", for example, must be scrutinized carefully - even if they are active-business related, and therefore might fit into the major exemptions offered for this type of investment**[2]**. In this respect, I believe there may be major issues where there are layers of FIEs. Look-through rules are limited by accounting practice: consolidated financial statements in according with Canadian or similar GAAP may be required**[3]**. With the possible exception of a controlled foreign affiliate, any substantial foreign investment, even if business-related, should be reviewed to make sure it is not caught by the rules. The more complex the structure, the more likely it is that issues may arise.

The various revisions to the FIE proposals have spawned virtual sub-regimes where special knowledge is required. Somewhere along the way it became apparent that the rules could adversely affect Canadian beneficiaries of non-resident estates and trusts – in situations where the non-resident trust proposals

themselves do not apply. The latest revisions make it pretty clear that, unless the estate or trust is completely discretionary (no default clauses allowed), the rules are in play.

Let me say it in plain words. If you are a beneficiary of a non-resident estate or trust, the general rule is that you must pay tax based on the interest factor applied to the entire trust's/estate's assets, even though you may receive only pennies. This makes sense? Here's another example: A person who has immigrated to Canada with a foreign life insurance policy will ultimately have to revalue the policy every year and pay tax on the increase**[4]**. C'mon, Jim. Some poor schmuck comes into Canada and he has to do this? How does he even go about it?

Let me be honest. I doubt that you're going to hop a plane to Hawaii. So is there any chance that you might make some changes to these proposals? I know, I know. They've gone all the way through the House of Commons, not to mention your own Department. But you have to admit it - a lot of this legislation is off the wall. Instead of helping Canadian businesses compete abroad, the FIE rules and other elements of our international tax policy are structured as if we were a superpower**[5]**.

Actually, this brings me to one last point. Having gone through some examples, let me give you my overview, straight from the middle of the Pacific. I honestly think that there is something terribly wrong going on here, not only with the legislation itself, but with the legislative process in your own Department – and I think you should fix it. These are not technical glitches I am talking about, they are stinkers. And by the way, while the biggest stinkers lie in the international area, there are other stinkers too (the restrictive covenant proposals spring to mind).

I know what you're thinking. If I'm carping about competitiveness, why haven't I carped about the double dip/tower proposals, which (speaking of harming competitiveness) replaced the restricted interest proposals in the March 2007 federal budget. You're probably getting so many letters from my colleagues down the street at King and Bay, I don't see the point.

Aloha

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[1] However, where the CFA holds an interest in a FIE, the income related thereto will be included in the CFA's FAPI, per proposed paragraph 95(2)(g.3).

[2] A participating interest in a non-resident entity will not be a FIE if either the "carrying value" of "investment property" (as defined in proposed subsection 94.1(1)) is not greater than 50% of all property held by the non-resident entity, or the principal undertaking of the non-resident entity is carrying on a business other than an "investment business" (as defined in proposed subsection 94.1(1)). See the definition of "foreign investment entity" in proposed subsection 94.1(1). In addition, a "qualifying entity" may be an "exempt interest". However, there is an "all or substantially all" test in respect to qualifying carrying values. Practitioners who are familiar with the capital gains exemption generally agree that relying on this test can be dangerous.

[3] Proposed paragraph 94.1(2)(a) provides that, in determining whether the particular non-resident entity is a foreign investment entity, if the "financial statements" of an entity reflect property, indebtedness, income or losses of a lower entity, the business and non-business activities, net accounting income (and so on) are deemed to be carried on by, owned (and so on) by the upper entity. As a general rule, "financial statements" must be consolidated, prepared in accordance with GAAP per the Accounting Standards Board of Canada or substantially similar GAAP. (See the definition of "financial statements" in proposed subsection 94.1(1); per proposed subsection 94.1(2)(b), GAAP of the Financial Accounting Standards Board of the US or the International Accounting Standards Board is "substantially similar".) Other look through rules require notification to the Minister; for example, proposed paragraph 94.1(2)(j) provides formulae to look through to the financial positions of a downstream entity, provided that the taxpayer has a "significant interest" in the entity (for corporations, 25% or more of votes and value).

[4] For further discussion of these issues, see "Clear and Present Danger, The Saga Continues" in the June edition of *Tax Notes*. I have had several comments about an anomalous provision in the proposed legislation relating to interests in non-resident trusts and estates which I did not mention in the article, so I thought I would mention it now. As stated above, the FIE "interest factor" is applied to the trust's assets. Per proposed clause

94.1(2)(c)(ii)(B), the designated cost of an interest in a trust or estate is based on the “cost amount” of the interest in the trust, per subsection 108(1), but a special “adjustment” ignores the normal reduction for debt owing by the trust. I am mystified by the rationale for this. In addition, the cost amount is based on the entire asset base of the trust. However, this amount is divided by the number of Canadian resident beneficiaries who are identified by the beneficiary in prescribed form, so that Canadian beneficiaries appear to get no relief where there are also non-resident beneficiaries.

[5] The FIE proposals are reminiscent of the US PFIC rules.