IFIC THE INVESTMENT FUNDS INSTITUTE OF CANADA
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DELIVERED BY COURIER

June 3, 2002

The Honourable John Manley, P.C., M.P.
Minister of Finance
Government of Canada
L'Esplanade Laurier
140 O'Connor Street
21st Floor, East Tower
Ottawa, Ontario
K1A 0S5

Dear Minister:

Re: Tax Treatment of Canadian Resident Shareholders under the Foreign Spin Off Rules in Section 86.1 of the *Income Tax Act* (Canada)

This letter is further to our earlier letter to Brian Ernewein dated February 9, 2001 (the "February/01 Letter") in which we expressed some of our concerns regarding the tax treatment of Canadian resident shareholders who have received a distribution from a foreign corporation that has undergone a foreign spin off under what was then proposed section 86.1 of the *Income Tax Act* (Canada) (the "Tax Act"). We have enclosed a copy of our February/01 Letter for your reference. We are writing now to draw your attention to some of the concerns we expressed to Mr. Ernewein in our February/01 Letter and to alert you to some additional issues that our members have raised regarding the operation of these new rules now that they have worked with these rules for more than 1½ years.

We are aware that others in our industry have raised these issues with you and we share their concerns.

Your Department has been very helpful and constructive in working with us over the years to solve important tax and other finance issues that arise for our industry from time to time. We are confident that we can work together with your Department to solve this issue as well in a manner that is mutually satisfactory to you and our industry.

By way of background, many Canadian, American and other international corporations have undergone corporate reorganizations, including spin off transactions, to rationalize their business activities in recent years. Generally, a spin off transaction is a divisive reorganization where shareholders of a corporation (the "distributing corporation") receive shares of another corporation which carries on a business (or owns assets) previously carried on (or owned) by the distributing corporation and continue to own

their shares of the distributing corporation. The shareholder's economic position has not changed as a result of this transaction.

Many foreign spin off transactions involve the payment of a dividend-in-kind in the form of shares by the distributing corporation to its shareholders. This dividend-in-kind is usually not taxable to shareholders resident in the same jurisdiction as the distributing corporation. Prior to the enactment of section 86.1, Canadian shareholders who received this dividend-in-kind were fully taxed in Canada on this amount, even if the spin off was tax-free or tax-deferred under the tax laws of the jurisdiction of the distributing corporation. The result for Canadian shareholders was that they were taxed on their original investment without having sold or otherwise disposed of their investment.

Section 86.1 of the Tax Act attempts to address the disparity between the tax treatment of foreign shareholders and Canadian shareholders who participate in a foreign spin off transaction. Although this provision is an important first step in acknowledging that the Canadian tax system must accommodate the global economy and recognize its effect on Canadian taxpayers, this provision does not accomplish these goals as currently drafted.

Under this new section, Canadian shareholders may elect to defer the tax on certain distributions of foreign spin off shares they receive from foreign corporations until they dispose of these shares provided the requirements under this section are met. Although this provision ostensibly offers relief to Canadian shareholders, unfortunately, for the Canadian investment funds industry it has had limited practical application. Based on our industry's experience with this rule since the Fall, 2000, the conditions for making an election under section 86.1 are complex and somewhat impractical with the result that this relief will only be available to Canadian investment funds (and other Canadian taxpayers) in quite limited circumstances.

As we described in our February/01 Letter, we have the following concerns with section 86.1:

- requiring foreign corporations to provide detailed information directly to the Canada Customs and Revenue Agency ("CCRA") (including written confirmation from domestic tax authorities verifying that the spin off is tax deferred under domestic tax laws) is impractical for many reasons. For example, a foreign distributing corporation may be unaware of Canadian tax requirements or may be unwilling or unable to comply with these requirements. Since Canadian shareholders in foreign corporations are in many cases minority shareholders, they do not have the ability to influence foreign corporations to provide the required information;

- the six month time frame for compliance by the foreign corporation with the requirements of section 86.1 is impracticable for Canadian investment funds who hold shares of a distributing corporation because such funds are required to calculate and determine the amount and character of their income for the year by the calendar year-end; and

- the requirement that the shares of the distributing corporation be "widely held and actively traded" is too restrictive and could be interpreted to prevent section 86.1 from applying where a corporation has a majority shareholder and the minority shares are relatively thinly traded as a result of a large minority discount; we also mentioned that the rules should apply to depository receipts that evidence the common shares of a corporation where the depository receipts are listed on a prescribed stock exchange, even if the common shares are not listed on a prescribed stock exchange.

This legislation has been in effect for more than 1½ years and we and our members have had a chance to further assess its practical impact. We would like to bring to your attention the following two additional problems with section 86.1 that our members have encountered with this legislation in practice:

- these rules require that the distribution consist solely of common shares of an existing corporation that the distributing corporation owned immediately before their distribution to shareholders. This is an impossible requirement for many foreign corporations to meet as it is in direct conflict with the domestic tax laws of many foreign countries (for instance, the United Kingdom and Mexico) which require the spun-off shares to be of a new corporation. For example, British Telecom's spin off in November, 2001 did not satisfy this requirement. In addition, CCRA stated at the May 13, 2002 International Fiscal Association Conference that if shares distributed by the foreign corporation on a spin off have attached shareholder rights under a shareholder's rights plan of the kind often referred to as a "poison pill" rights plan, then Canadian shareholders will not be eligible for the relief under section 86.1; and

- for non-US spin offs to qualify for the section 86.1 election, the foreign corporation must submit a request to the CCRA's International Tax Directorate and ask that the distribution be prescribed by new regulations to be promulgated under the Tax Act. Despite the election under section 86.1 having been available since 1997, no such regulations have been promulgated to date and so no non-US spin offs have ever benefited from this election even though several of such transactions occur each year.

Thus, we respectfully submit that the foregoing issues must be addressed in an amendment to section 86.1. In summary, we request that the following changes be made to the legislation:

(a) an amendment to section 86.1 which shifts the onus of providing information to the CCRA concerning the spin-off to the Canadian shareholder from the foreign distributing corporation;

(b) an amendment to the procedural requirements required of the CCRA, the foreign distributing company and the Department of Finance to allow time for various mutual funds and other investment funds who have invested in the foreign distributing corporations to calculate and distribute their income to their unitholders taking into account the application of section 86.1 by the investment funds;

(c) an amendment to the language in section 86.1 which currently limits its scope to distribution in the form of shares of existing corporations and does not extend to distribution in the form of shares of a newly established corporation and an amendment that the spin-off is not disqualified if rights under a poison pill are attached to the spin-off shares;

(d) an amendment to section 86.1 that deletes the requirement that new regulations be promulgated for each non-US spin off and replace it with new language requiring the same information as that needed for US spin offs; and

(e) an amendment to section 86.1 to ensure that it applies to depository receipts evidencing common shares of the foreign corporation where the depository receipts are listed on a prescribed stock exchange.

Thank you for your time and attention to this matter. We would welcome the opportunity to meet with you or members of your Department in the near future to discuss this further and would be pleased to assist you with drafting amendments to section 86.1.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

"ORIGINAL SIGNED BY J. MOUNTAIN FOR HON. T.A. HOCKIN"

Hon. Thomas A. Hockin
President and Chief Executive Officer

Enclosure

cc: Brian Ernewein, Department of Finance