The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants

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Mr. Brian Ernewein
General Director, Tax Legislation Division
Tax Policy Branch
Department of Finance Canada
L'Esplanade, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G5

Dear Mr. Ernewein,

Re: May 7, 2010 Department of Finance Backgrounder on Proposals to Require Information Reporting of Tax Avoidance Transactions

We are pleased to provide the attached submission for your consideration. We would like to thank the Minister of Finance as well as your Department for providing the tax community and other interested parties with the opportunity to provide comments on the proposals before the draft legislation is released. As we note in our submission, we also recommend that the tax community and other interested parties should have an opportunity to provide comments on the draft legislation before it is implemented.

Our submission identifies a variety of issues raised by the members of the tax community related to the May 7, 2010 Backgrounder. We trust that you will find our comments and recommendations helpful. We would be pleased to meet with you and your colleagues to discuss any of the issues raised in this submission.

Yours truly,

D. Bruce Ball	Darcy Moch
Chair, Taxation Committee	Vice-Chair, Taxation Section
Canadian Institute of Chartered Accountants	Canadian Bar Association

Submission of the Joint Committee on Taxation of The Canadian Bar Association and
The Canadian Institute of Chartered Accountants

May 7, 2010 Department of Finance Backgrounder on Proposals to
Require Information Reporting of Tax Avoidance Transactions

INTRODUCTION

This submission sets out our comments and recommendations on the Backgrounder released on May 7, 2010. Based on our analysis of the announcement of this initiative in the 2010 Federal Budget and the Backgrounder, we believe that the goal of the proposals is to require the reporting of transactions where there is reason to believe that the general anti-avoidance rule (GAAR) *may* apply, but only in instances where there is "aggressive tax planning, which can undermine the integrity of our income tax system". We appreciate that the Federal Government has an interest in requiring the reporting of aggressive tax planning transactions, and that enhanced reporting exists in other countries as well; however, we believe that the rules that are ultimately enacted must be precise and clear in application, and should be limited in focus to the narrow class of transactions that threatens to undermine the integrity of the tax system.

As stated in the Backgrounder, a reportable transaction will only arise to the extent that the transaction bears at least two of three "hallmarks" of aggressive tax planning. These hallmarks involve:

- whether a promoter or tax advisor is entitled to receive a certain type of fee in respect of the transaction or the tax benefit;
- whether the promoter or tax advisor requires "confidential protection" with respect to the transaction; and
- whether the taxpayer obtains "contractual protection" in respect of the transaction.

From this, we take it that the proposals are intended to only apply to transactions that some may view as egregious in that they fundamentally undermine our tax system. We submit that such transactions would be more the exception than the norm.

As an important, overall recommendation, the Joint Committee believes the detailed rules for implementing this proposal should be carefully drafted so that the reporting requirement does not extend to transactions that do not meet the spirit of the rules as set out above. However, based on some of the information in the Backgrounder, we believe that, depending on how the draft legislation is worded, several of the proposed concepts could be too broad and could cause significant problems.

We also believe that imposing reporting obligations and penalties directly on advisors risks undermining the fiduciary relationship between advisors and clients. Unless the application of these rules is narrowed to ensure it does not extend to “routine” tax advice provided in the normal course by advisors in their clients’ best interests, serious ethical and professional concerns will arise.

In this submission, we identify some potential issues that could arise, depending on the wording of the draft legislation, and set out our recommendations for resolving these issues. Specifically, we provide our views and recommendations on the following topics:

- Reportable transactions and hallmarks
  - Fee Hallmark
  - Confidential Protection Hallmark
  - Contractual Protection Hallmark
- Reporting Issues
- Penalty Provision Concerns
  - Scope of Definition of Tax Advisors
  - Conflicts Between the Proposals and Professional Rules of Conduct
  - More Clarity Required on Joint and Several Liability
  - More Clarity Required for Due Diligence Exception
- Application of Rules
- Application Date
- Next Steps

We would also be pleased to meet with members of your Department to discuss our submission in more detail. The Joint Committee may want to make a further submission on the draft legislation once it is released.

REPORTABLE TRANSACTIONS AND HALLMARKS

Under the Backgrounder, a transaction or series of transactions will be subject to the proposed reporting rules if the transaction is an avoidance transaction and two of three hallmarks apply. In summary, these hallmarks are a fee hallmark, a confidentiality hallmark and a contractual protection hallmark.

As an "avoidance transaction" can include any transaction entered into to achieve a tax benefit (unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit), avoidance transactions or "near avoidance" transactions are common. Therefore, it is crucial that the three hallmarks are carefully and precisely defined. We have summarized our concerns with the three hallmarks below.

Fee Hallmark

The Committee believes that the proposed definition for the fee hallmark needs to be precise. We anticipate that whether or not a transaction involves a contingency fee (the second test in the fee hallmark) is an objective measure and we do not have any concerns on this test (other than in respect of contingency claims regarding SR&ED matters or tax litigation, as discussed below). However, the other two tests within the fee hallmark are quite subjective and may create significant concerns, depending on how the proposed legislation is drafted.

The first test in the fee hallmark refers to "fees that are to any extent attributable to the amount of the tax benefit from the transaction". In any transaction, the amount paid is always somehow attributable to the value or the benefit received from the good or service acquired. This applies to tax advice and to any other good or service. Although professionals generally bill based on time, they also bill for specialized knowledge and know-how that they have transferred to a client. They may do this through a higher hourly rate or may simply "value" bill for the know-how and knowledge that is brought to bear in respect of the transaction. Many clients prefer this approach, and it does not necessarily indicate that the transaction is aggressive in tax terms. We are concerned that the "to any extent attributable" language could apply to these common fee arrangements. We are also concerned that this broad concept could inadvertently cover fees that are not related to tax planning. For example, consider services provided by a professional firm in respect of a large commercial transaction where only a small percentage of the overall fee relates to the tax advice; clearly, in these circumstances, it would be inappropriate to capture the non-tax related fees for purely commercial matters as part of the "fee … described in a hallmark".

As mentioned earlier, the reporting rules should only be of a concern where there is advice relating to a tax benefit, but invariably there may always be a relationship between the amount of the tax benefit (i.e. the value of the tax advice provided) and the fee charged. Consequently, the wording in the draft legislation on this point must be precise.

The third test in the fee hallmark refers to "fees that are to any extent attributable to the number of taxpayers who participate in the transaction or who have been provided access to advice…". Again, this hallmark does not recognize commercial reality in terms of providing advice to clients. Where the same or similar advice is provided to multiple clients, the time and effort needed to implement the advice decreases. However, the fee may not be reduced in many cases, as again valuable knowledge and know-how may be transferred to the client.

Recommendations:

We recommend significantly narrowing the proposed definition for the fee hallmark and specifying a direct correlation between the tax benefit and the fee. A reference to fees being "to any extent attributable" to tax benefits will cause this hallmark to be met in far too many situations, as will a reference to fees being "to any extent attributable to the number of taxpayers who participate in the transaction or who have been provided access to advice given by the promoter or tax advisor". For this reason, we recommend that the fee hallmark be confined to contingency matters, that is, where the entitlement of the advisor or promoter to receive the fee is tied directly to whether the tax benefit is ultimately realized. In contrast, a fee that is based on a prospective tax benefit but not reduced or refunded if the tax benefit is not actually realized should not be subject to the fee hallmark.

Concern has also been raised as to whether this rule would catch contingency work, such as preparing filings for SR&ED claims and tax litigation. Based on the wording of the Backgrounder, we believe that such contingency fees are based on the work needed to report on or deal with completed transactions, rather than implementing avoidance transactions. Contingent fees are used in these circumstances as it is often difficult to estimate the time needed for the work, and clients often do not want to pay a fixed

fee without some idea of the actual benefit. Due to the level of the concern we have seen on this point, we recommend that the Department of Finance or the Canada Revenue Agency (CRA) specifically clarify that these contingency fee engagements in respect of completed transactions are not subject to the fee hallmark.

Confidential Protection Hallmark

Under the definition, “confidential protection” with respect to a transaction means "any limitation on disclosure" to any other person, including the CRA, that is placed by the promoter or the tax advisor on the taxpayer, in respect of the details or the structure of the avoidance transaction that gives rise to any tax benefit. Although the definition excludes a disclaimer of liability where a third party relies on an opinion, many professionals seek to limit the general confidentiality of client advice more directly by stating that the advice given cannot be passed on to others. Many professionals use this approach for all advice and such a condition is common in engagement letters. Such a condition may be also combined with the third party liability exception discussed in the Backgrounder.

Recommendation:

The conditions of this hallmark should be revised to compare the level of confidentiality for advice related to the avoidance transaction to the level of confidentiality for client advice in general. That is, the hallmark should test whether additional confidentiality conditions were imposed that go beyond common practices for professional advice in general.

Contractual Protection Hallmark

The third hallmark refers to situations where the taxpayer or the person who entered into the transaction for the benefit of the taxpayer obtains “contractual protection” in respect of the transaction (otherwise than as a result of a fee described in the fee hallmark). Committee members have raised concerns that the reference to contractual protection in this hallmark is too vague. This hallmark is no doubt designed to capture situations where conditions are put in place to guarantee a tax benefit, but it does not acknowledge that adjustments may be made due to other factors.

For example, a fee may be later discounted due to unexpected tax results or other client dissatisfaction issues. Or, a change in factual conditions may affect the tax benefit and may call for a fee reduction or transaction price adjustment.

We also note that this hallmark does not apply where the “contractual protection” is built into the fee itself. We question then why this is a separate hallmark as fee and contractual protection hallmarks are directed at the same issue.

One very common situation we would note is the sale of shares of a corporation where the vendor represents and warrants that the corporation has a specified amount of tax attributes (tax pools, CCA, etc.) and agrees to indemnify the purchaser for any diminution in these tax attributes. Clearly, we assume that Finance does not intend such a form of commercial indemnity to be “contractual protection” or the vendor to be a “tax advisor” (i.e. a person that provides contractual protection).

Recommendations:

As with the fee hallmark, we believe that the contractual protection hallmark must specify that such protection be related specifically to the success or failure of the tax planning advice that is directly related to the tax benefit and not common commercial terms that may compensate for various events. Also, this hallmark should be combined with the fee hallmark, in the sense that the contractual protection is provided by the promoter or tax advisor, rather than a third party.

REPORTING ISSUES

The Backgrounder provides little detail on the nature of the reporting that will be required. The Committee believes that the application of the reporting requirement to a series that extends past one year should be reviewed. For example, if a reportable transaction includes the acquisition of a depreciable asset, will reporting be required each time capital cost allowance is claimed? We suggest that reporting the transaction or series once is appropriate and the detailed rules should address this.

In terms of the impact of a disclosure on a subsequent CRA review, the Backgrounder states that the "disclosure of a reportable transaction would not be considered in any way as an admission that the General Anti-Avoidance Rule (GAAR) applies to the transaction, or that the transaction is an avoidance transaction for the purpose of the GAAR." This concept should be extended broadly to state that a disclosure is not an admission of any of the matters contained in the reporting, including, for example, that the transaction is an avoidance transaction, that the steps of the transaction form a series or even that the transaction necessarily produces a tax benefit. In the context of the tax shelter rules, subsection 237.1(5) provides that investors must be informed that the issuance by CRA of a tax shelter number is for administrative purposes only and does not confirm that an investor is entitled to tax benefits. We believe a similar approach is warranted in these circumstances, and that the CRA and the Courts must be instructed that reporting is strictly a procedural matter. In particular, the rules should specifically provide that the reporting is for administrative purposes only (i.e., to allow CRA to more easily identify the transaction), and the filing of the required form by the taxpayer cannot itself be used, directly or indirectly, as a basis to assert or conclude that the taxpayer is not fully entitled to the tax benefits sought.

We also note that the requirement to report applies to a person who seeks to obtain a tax benefit from a reportable transaction, as well as any person who enters into such a transaction for the benefit of a taxpayer. The Backgrounder provides an example of a corporation that would be subject to the reporting rules in respect of a transaction that has a tax benefit that accrues to a current or future shareholder of the corporation. The example implies that each of the corporation's current and former shareholders would be required to report the transaction. We believe that in many situations shareholders would not necessarily even know that a reportable transaction has taken place. Likewise, we are concerned that the scope of the rules may create issues with directors and officers of corporations, trustees and beneficiaries of trusts, the managing partner and the other partners of a general partnership, and the general partner and limited partners of a limited partnership.

Recommendation:

We recommend that the reporting obligation be confined to those who have entered the transaction.

PENALTY PROVISION CONCERNS

Committee members raised a number of fundamental concerns about the penalty rules. Consistent with the spirit of the rules, we believe that the penalty provisions must have a more direct focus. We have summarized our specific observations and recommendations below.

We note that references to tax promoters and tax advisors are used interchangeably in the Backgrounder; we believe that assimilating the distinct roles of tax promoters and tax advisors is unwarranted, and leads to numerous inappropriate results. A tax advisor that provides advice in the normal course should not be placed on the same footing as a promoter that aggressively markets a tax product. In addition, while a tax promoter would have a direct link to the transaction or series of transactions, that would not necessarily be the case for a tax advisor based on the wording of the Backgrounder. Also, due to the number of potential tax advisors and promoters, we believe there will be uncertainty regarding which party has primary liability for the penalty. We have summarized our specific concerns below.

Definition of Tax Advisors

A tax advisor includes any person who provides "any aid, assistance or advice with respect to organizing or implementing an avoidance transaction entered into by or for the benefit of a taxpayer". As defined, tax advisors may not even know that they have met the test if they have been engaged to provide specific services with respect to the transaction. For example, a commercial lawyer who is engaged solely to document a transaction may be a "tax advisor". Although there is a due diligence test, this issue should be dealt with by tightening the definition of a tax advisor to include only those persons who directly provide tax advice to the taxpayer in respect of the transaction.

The fact that tax advisors to other tax advisors are also caught by the rules will cause further problems. When an advisor assists another advisor, that second-tier advisor may not even know who the client is or how the advice is being put to use. Even if the second-tier advisor knows these details, he or she may not necessarily know whether the advice has actually been implemented.

Recommendation:

Confining the penalty (and any joint and several liability in respect of any penalties) to the portion of the fees to which each promoter or tax advisor is or would be entitled to receive is helpful in this regard. However, we recommend that the fees in question for each promoter or tax advisor liability for penalties must be the fees that would meet the fee test in the fee hallmark. In this way, only those promoters or tax advisors who have received what might be considered to be aggressive fees would be exposed to penalties.

Conflicts Between the Proposals and Professional Rules of Conduct

Although it appears that the primary reporting requirement lies with the taxpayer (which we recommend should be confirmed), the proposals indicate that the reporting requirements will fall to all tax advisors and promoters along with the taxpayer due to their joint and several liability for the penalty. This reporting requirement results in a direct conflict as it could require professional tax advisors to breach their rules of conduct to comply. Disclosing information about a client to the CRA would normally be a breach of confidentiality rules for most professionals. In the case of lawyers, the issue goes beyond confidentiality as they are subject to rules of solicitor-client privilege and are not permitted to take actions that endanger this privilege.

In addition, a professional has a duty to act in the best interests of the client. The professional will typically provide advice to a client in an objective, independent and unbiased manner, and the client will assess the benefits and risks of the transaction and then decide whether or not to proceed. By placing reporting and penalty obligations on an advisor, the advisor may also be forced to consider the implications of the transaction to the advisor; this may compel the advisor to put his or her interests ahead of the client's. Even if the professional does not actually put his or her interests first in practice, the possibility that he or she could so still creates a potential conflict of interest or a lack of independence. Such a dynamic threatens to seriously erode the normal features of a professional-client relationship. We believe that it is inappropriate for tax legislation to put a professional in such a situation.

This issue may be even more unfair for secondary advisors, who may have more trouble extraditing themselves from such a situation. In addition to a prohibition from disclosing confidential information, it may be difficult to withdraw from an engagement if a tax advisor becomes aware of a reportable transaction. If the work has already commenced, a withdrawal from the engagement would not be effective based on the wording in the Backgrounder. If work has not commenced, there can still be an issue for the advisor if their withdrawal creates a cost for the client. In such a case, the tax advisor may be liable for damages.

More Clarity Required on Joint and Several Liability

In the case where there are multiple tax advisors and/or promoters, the Backgrounder provides no information on how joint and several liability would be applied or how the penalty would be collected. In particular, could the penalty be collected more than once? Who would have primary responsibility for paying the penalty? With such a broad definition of who is considered to be a tax advisor, professionals could be conflicted with each other on a variety of issues and, as noted above, their interests may conflict with their client's.

More Clarity Required for Due Diligence Exception

Committee members raised concern over the lack of clarity on the due diligence exception, particularly regarding the following issues:

- From what perspective is the exception being applied? Will it vary from professional to professional based on his or her involvement?

- Where a professional's rules of conduct forbids the disclosure of personal information, would such rules provide a valid due diligence argument for not reporting the transaction?
- Will all parties involved in a reportable transaction have to review the disclosure to ensure it is complete?
- For secondary advisors who do not know all of the facts, will the fact that a disclosure has been made suffice to establish a due diligence exception?
- If a secondary advisor does not have access to sufficient facts to establish whether a transaction is reportable or not, will that suffice to establish a due diligence exception for that advisor?

Recommendations:

1. As the decision to implement a reportable transaction is ultimately the taxpayer's, the reporting and penalty obligations should apply to the taxpayer only. If the taxpayer's advisors do not point out the reporting requirement and related penalty to the taxpayer, the taxpayer may have other legal means to recover the cost of the penalty from their advisors.
2. Failing recommendation 1, the proposals should be amended to recognize that a number of advisors could potentially be involved in setting up a reportable transaction, but there is generally a smaller circle of key decision-makers, including the taxpayer and those described as tax promoters (i.e., those who market a tax product). The joint and several liability to the failure-to-report penalty should be restricted to this group and should not extend to professionals that provide tax advice in the ordinary course (i.e., professionals who have not received contingent fees as described above).

APPLICATION OF RULES

Similar to the application of GAAR, we believe that the decision to apply the reporting rules should be made by a centralized group (like the GAAR committee) and not by individual auditors.

APPLICATION DATE

As currently drafted, the proposals apply to avoidance transactions entered into after 2010 and avoidance transactions that are part of a series of transactions that commenced before 2011 and are completed after 2010. Thus, an avoidance transaction that was completed before 2011 is subject to the rules if it is part of a series that stretches into 2011. A number of concerns arise with this approach. First, the series of transaction test can extend back many years. Second, it is not always clear whether transactions form part of a series. We are therefore concerned that the reporting rules will be both retroactive in nature and uncertain in application. It is unreasonable to expect that taxpayers and their advisors could review all past transactions in a meaningful way to determine if a reporting obligation might exist. At a minimum, the effective date should be amended so that the proposals apply to avoidance transactions entered into after 2010. Also, we strongly believe that a series of transactions

should only be subject to the rules if it commenced after March 4, 2010 (when this proposal was first announced).

NEXT STEPS

The Committee appreciates the Department of Finance's initiation of public consultations before legislation is drafted and released. However, given the Backgrounder's general nature and the possible impact of these rules, we believe that the draft legislation for this proposal should be the subject of another round of consultations. We also believe that it would be useful for the Canada Revenue Agency to release a draft version of the reporting form to allow for a more thorough review of the proposals' impact on taxpayers and their advisors.

We thank you for the opportunity to submit our views on these proposals and we would be pleased to meet with members of your Department to discuss our submission in more detail. The issues are complex and a meeting to discuss the impact on taxpayers, advisors and promoters in their different roles is likely best communicated through a more detailed discussion. The Joint Committee may want to make a further submission on the draft legislation once it is released.

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