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

The Canadian Institute of Chartered Accountants 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

February 15, 2013

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

Re: December 21, 2012 Technical Amendments

Mr. Ernewein,

Enclosed is our submission on the amendments that were released by the Department of Finance on December 21, 2012.

Several members of the Joint Committee participated in discussions concerning our submission and contributed to its preparation, in particular:

Jeff Trossman (Blakes LLP)
K.A. Siobhan Monaghan (Davies Ward Phillips & Vineberg LLP)
D. Bruce Ball (BDO Canada LLP)
Kim G.C. Moody (Moodys LLP)
Mitch Sherman (Goodmans LLP)
Darcy D. Moch (Bennett Jones LLP)
Anthony V. Strawson (Felesky Flynn LLP)

The Joint Committee would also like to acknowledge the assistance of Rick McLean of KPMG LLP.

We trust that you will find our comments helpful and would be pleased to discuss them with you at your convenience.

Yours very truly,

Penny Woolford
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Darcy D. Moch
Chair, National Taxation Section
Canadian Bar Association

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants is pleased to provide you with this written submission on certain aspects of the draft legislative proposals released on December 21, 2012 relating to the divisive reorganization rules in subsection 55(3), the "bump denial" rules in section 88, and Part XI.01 in respect of registered retirement savings plans ("**RRSPs**"), registered retirement income funds ("**RRIFs**") and tax-free saving accounts ("**TFSAs**") (the "**Legislative Proposals**").

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the *Income Tax Act* (Canada) (the "**Act**") as proposed to be amended under the Legislative Proposals.

A. <u>Changes to Section 55</u>

1. Paragraph 55(3.01)(g)

Proposed paragraph 55(3.01)(g) implements a comfort letter dated September 6, 2006 (the "**September 2006 Letter**"). The scope of proposed paragraph 55(3.01)(g) appears narrowly tailored to address only the situation considered in the September 2006 Letter. However, there are a number of similar scenarios in which the exemption in paragraph 55(3)(a) remains unavailable notwithstanding that all of the criteria of proposed paragraph 55(3.01)(g) are satisfied.

In the situation described in the September 2006 Letter, less than 10 percent of the value of the shares of each of Targetco and Acquireco are derived from each of TSub, ASub, and Newco. Accordingly, no event described in subparagraph 55(3)(a)(iii) occurs. However, if the shares of Targetco did derive more than 10 percent of their value from shares of TSub, an event described in subparagraph 55(3)(a)(iii) would have occurred and the paragraph 55(3)(a) exemption would be denied. This would be the case notwithstanding that the submissions in support of the amendment described in the September 2006 letter (see third last paragraph) equally apply to this fact pattern.

Likewise, consider the following situation. A corporation, Acquireco, simultaneously acquires, from a vendor, the shares of two separate Canadian corporations, Canco 1 and Canco 2, and subsequently wishes to rely on the paragraph 55(3)(a) exemption to transfer assets between Canco 1 and Canco 2 on a tax-deferred basis. In this regard, Acquireco transfers shares of Canco 1 to Canco 2 in consideration for shares of Canco 2 on a tax-deferred basis pursuant to an election under subsection 85(1). Canco 1 then transfers assets to Canco 2 in consideration for preferred shares of Canco 2. The shares of Canco 2 held by Canco 1 and the shares of Canco 1 held by Canco 2 are cross redeemed. Canco 1 is deemed to have paid a dividend to Canco 2 and Canco 2 is deemed to have paid a dividend to Canco 1. As such, each of Canco 1 and Canco 2 is a dividend payer and a dividend recipient. As Acquireco was not related to Canco 2 when it acquired shares of Canco 1 and was not related to Canco 1 when it acquired shares of Canco 2, the acquisition of those shares would be an event described in subparagraphs 55(3)(a)(iii) and (v)[1] and the exemption in paragraph 55(3)(a) would not be available. Yet again, all of the conditions of proposed paragraph 55(3.01)(g) would be met.

In other cases, proposed paragraph 55(3.01)(g) will not be satisfied even though the application of subsection 55(2) appears to be inappropriate. Consider the situation in the September 2006 Letter with the following modifications. First, assume that ASub is indirectly owned by Acquireco through ASub-Parent. Second, rather than ASub acquiring shares of TSub after TSub divested itself of certain assets to Newco, TSub may wish to transfer certain assets to ASub on a tax-deferred basis followed by a redemption of the ASub shares issued to TSub. Such a transaction would not satisfy the requirements of proposed subparagraph 55(3.01)(g)(v). More particularly, Acquireco's acquisition of shares of Targetco is an event described in subparagraph 55(3)(a)(ii) and Targetco is a "particular corporation" as that term is used in proposed paragraph 55(3.01)(g). Proposed subparagraph 55(3.01)(g)(v) requires that all of the shares of each of TSub and ASub be held by Targetco, a corporation that controls Targetco, a corporation controlled by Targetco, or a combination thereof. As ASub-Parent is a subsidiary of Acquireco, ASub-Parent would not be described by proposed subparagraph 55(3.01)(g)(v) and the exemption in paragraph 55(3)(a) would not be available.

The requirements of subparagraph 55(3.01)(g)(v) would also not be met where shares of a dividend payer or dividend recipient are held, for example, by a partnership.

<u>Recommendations:</u>

Specifically, we recommend that proposed paragraph 55(3.01)(g) be amended to apply to transactions or events that would otherwise be described in any of subparagraphs 55(3)(a)(i) through (v) so that such transactions or events not be considered to have occurred where the requirements of proposed paragraph 55(3.01)(g) are met.

We recommend that proposed subparagraph 55(3.01)(g)(v) be amended to read as follows:

> (v) at the time the dividend was received, all the shares of the capital stock of the dividend recipient and the dividend payer were owned by the particular corporation, <u>a corporation related to the particular corporation</u> or any combination of those corporations;

2. Clause 55(3.1)(c)(i)(A)

Proposed clause 55(3.1)(c)(i)(A) implements a comfort letter dated June 8, 2005 (the "**June 2005 Letter**"). The June 2005 Letter describes a case in which a distributing corporation sells some but not all of its shares of a corporation for cash proceeds equal to fair market value before a butterfly transaction. The problem identified is that the shares disposed of are property described in clause 55(3.1)(c)(ii)(B).

[1] If, rather than simultaneous acquisition, Acquireco acquired shares of Canco 1 before acquiring shares of Canco 2, only its acquisition of Canco 1 shares would be an event described in subparagraphs 55(3)(a)(iii) and (v). Nonetheless, the exemption in paragraph 55(3)(a) would remain unavailable.

Although the proposed amendment to clause 55(3.1)(c)(i)(A) will correct that problem, another related issue remains unaddressed. Consider the following situation. Aco and Bco each own 50 percent of the shares of Holdco. Holdco's only asset is shares of a publicly traded corporation, Pubco. A "single-wing (split-up) butterfly" is undertaken such that Aco holds 50 percent of the Pubco shares that Holdco held prior to the transaction and Bco holds all of the shares of Holdco. Subsequently, Holdco sells some or all of its Pubco shares as part of the series of transactions that include the butterfly dividends. The Pubco shares are property described in clause 55(3.1)(d)(ii)(A) and the sale of shares would preclude reliance on the exemption in paragraph 55(3)(b) in respect of the dividend received by Holdco. This result is appropriate in the context of the objective of the butterfly rules. However, the Pubco shares are also property described in clause 55(3.1)(c)(ii)(B) and the sale of Pubco shares by Holdco would result in a loss of the paragraph 55(3)(b) exemption in respect of the dividends received by Aco. (The same would be true were the property transferred on the butterfly shares of a private corporation, partnership interests, or interests in a trust.) This result is anomalous. If the property transferred on the butterfly were, for instance, real property, a sale by Holdco of that property would not affect the treatment of the dividend received by Aco. There is no principled reason why shares, partnership interests, or interests in a trust should be treated differently.

Recommendation:

We recommend that paragraph 55(3.1)(c) be amended to rectify the above anomaly.

3. Clause 55(3.1)(d)(i)(A)

The proposed amendment to clause 55(3.1)(d)(i)(A) mirrors the proposed amendment to clause 55(3.1)(c)(i)(A). The discussion in section A.2. above applies were the facts modifies such that Aco rather than Holdco sells Pubco shares after the distribution. In such circumstances, clause 55(3.1)(d)(ii)(B) would apply to deny the paragraph 55(3)(b) exemption in respect of the dividend received by Holdco.

Recommendation:

We recommend an amendment to paragraph 55(3.1)(d) that mirrors the amendment recommended to paragraph 55(3.1)(c).

B. Changes to Section 88

1. Subparagraph 88(1)(c.2)(i)

A "specified person" is defined in subparagraph 88(1)(c.2)(i) for purposes of section 88. The Legislative Proposals propose to amend that definition to, among other things, allow a person to be a specified person before the incorporation of the parent (as that term is used in section 88) by the addition of clause (C). As proposed, that provision will apply to treat as a specified person, at any time before the parent is incorporated, each person described in clause (B) "who is related to the parent throughout the period that begins at the time the parent is incorporated and ends at the time that is immediately before the beginning of the winding-up." We are concerned that the proposed amendment does not quite achieve the intended objective because, at the time the parent is incorporated, it will not be related to anyone – no shares can be issued until after it is incorporated – with the result that there will be no person related to the parent <u>throughout</u> the identified period.

<u>Recommendation</u>:

We recommend that clause 88(1)(c.2)(i)(C) be amended to read as follows:

> if the time is before the incorporation of the parent, …the period that begins at the time at which <u>the parent first issued any share of its capital stock</u> and ends at the time that is immediately before the beginning of the winding-up;

2. Subparagraph 88(1)(c.2)(iii)

Subparagraph 88(1)(c.2)(iii) provides two rules that apply in determining whether a person is a specified shareholder of a corporation for purposes of the "bump denial" rules. The Legislative Proposals contain two amendments which are intended to address comfort letters previously issued by the Department.

Proposed clause (A.2) will permit a paragraph 251(5)(b) right to be ignored for the purposes of the specified shareholder definition only where the right in question is a right to acquire shares of a corporation controlled by the subsidiary which corporation does not have a direct or an indirect interest in the subsidiary. While direct or indirect interest is not defined for this purpose, we note that proposed clause (A.1) limits the inquiry required, for purposes described there, to a direct or indirect interest *in any of the shares of the capital stock of the* relevant corporation. We also observe that the August 13, 2004 comfort letter to which the proposed amendment in clause (A.2) relates refers to "a direct or indirect interest in any of the issued shares of the upstream corporation".

The contrast between the two proposed provisions is notable and, as a result, we are concerned that the phrase "direct or indirect interest in the subsidiary" in clause (A.2) could be given broader scope than intended. For example, if the downstream corporation is a creditor of the subsidiary, the downstream corporation might be considered to have an interest in the subsidiary. This cannot have been intended.

<u>Recommendation</u>:

Consistent with the August 13, 2004 comfort letter and proposed clause 88(1)(c.2)(iii)(A.1), we recommend that proposed subclause 88(1)(c.2)(iii)(A.2)(II) be amended to read as follows:

> (II) does not have a direct or an indirect interest in <u>any of the shares of the capital stock of</u> the subsidiary, and

3. Subparagraph 88(1)(c.3)(i)

(a) <u>Time of Measurement</u>

The proposed change to subparagraph 88(1)(c.3)(i) to add a safe harbour for property that derives not more than 10% of its fair market value from property distributed by the subsidiary on the winding up is a welcome change that will simplify the application of the "bump denial" rules and will go some distance toward relieving the need to create an exhaustive list of acceptable properties through expansion of the definition of specified property. However, it appears that substituted property under the proposed amendment will nonetheless include property (other than specified property) acquired by a person described in clause 88(1)(c)(vi)(B) as part of the series of transactions that includes the winding-up if <u>at any time after the acquisition of control</u> more than 10% of the fair market of the property is attributable to property or properties distributed on the winding-up. Therefore, the new safe harbour, as currently worded, leaves considerable uncertainty as to its potential application in practice.

The proportion of the fair market value of a property that is derived from other property may change over time for many reasons, including market forces, currency exchange rate changes or other events that could not have been predicted with any degree of certainty. Consider the following example. Assume the shareholders of Target sell their Target shares to Bidco, a wholly-owned subsidiary of USCo, in exchange for cash and USCo common shares. USCo's outstanding capital consists solely of common shares. Bidco intends to make a designation under paragraph 88(1)(d) in respect of Target's property that is not ineligible property. Immediately following the acquisition, the USCo shares derive only 8% of their value from Target's property that will be distributed to Bidco on the winding-up of Target (the "Distributed Property"). Assume that over some period following the distribution (say three or four months), the fair market value of USCo's assets other than the Distributed Property decreases and/or the fair market value of the Distributed Property increases (potentially well after the time control was acquired), so that more than 10% of the value of each USCo share is then derived from the Distributed Property. In such circumstances it is not clear that the exception would continue to be available because, at a time after the acquisition of control, more than 10% of the fair market value of the USCo shares (property acquired as part of the series of transactions that includes the acquisition of control) would be derived from the Distributed Property. As noted above, this shift in relative values could occur for many reasons that are impossible to predict and consequently will be difficult in practice to monitor.

The requirement to assess the fair market value of the property <u>at any time</u> after the acquisition of control will significantly limit its utility and thereby undermine the stated purposes of the amendment. In our view, these negative features of the safe harbour as proposed could be overcome by specifying that the 10% test need be met only at a particular time (most logically, immediately following the acquisition of control or the date the property is acquired, if later than immediately following the acquisition of control). While we recognize that a point in time test may be open to abuse, in our view, the appropriate way to address potential abuse is through an anti-avoidance rule. A model for such rule might be the anti-avoidance rule found in paragraph 212.3(14)(f).

(b) <u>Exchangeable Shares</u>

As noted above, the proposed safe harbour will permit the consideration paid for the subsidiary shares to include shares of a non-resident corporation. Historically, CRA has taken the position that exchangeable share transactions are inconsistent with a "bump" under paragraph 88(1)(d) because any exchange of the exchangeable shares issued by the Canadian corporation for shares of the foreign corporation would be part of the series of transactions that includes the acquisition of control of the subsidiary. Because such foreign corporation shares could derive some value from distributed property, they would be property described in subparagraph 88(1)(c.3)(i) (and would not be specified property).

Following the proposed amendment, we anticipate that there may be renewed interest in exchangeable share transactions, in reliance on the 10% safe harbour, in the context of an acquisition in which a "bump" is also desirable. An exchangeable share transaction would presumably only be effected to provide the selling shareholders with a tax deferral, and so would reduce the cost of the subsidiary's shares and the "total bump room". Exchangeable shares are intended to, in economic terms, treat the holder of the shares as if it had exchanged the shares for shares of the foreign parent. To that end, holders of exchangeable shares typically are given certain limited contractual rights including a right to "put" the exchangeable share to the foreign parent (in exchange for the foreign parent shares it would be entitled to acquire on an exchange with the issuer) if the exchangeable share issuer is unable to deliver the foreign parent shares upon redemption because of an insolvency event (an “insolvency put”) and a right to exercise votes at the foreign parent shareholders' meetings as if the exchangeable shares had been exchanged. These so-called ancillary rights are considered to have little value but are important to ensuring that the exchangeable shares are a very close proxy for a direct holding of the foreign parent shares.

Between the date the exchangeable shares are issued and the date they are exchanged for the foreign parent's shares, the value of the foreign parent's shares may have increased significantly. In our view, because the exchangeable shares and ancillary rights together are intended to be the equivalent of the foreign parent shares, in applying the 10% safe harbour test to exchangeable shares, such shares should be valued as if they were exchanged on the date they are acquired, rather on the date they are actually exchanged, and the ancillary rights should be ignored provided they are typical ancillary rights (i.e., an insolvency put and/or a right to vote at shareholders' meetings of the foreign parent as if the exchangeable shares had been exchanged). In other words, while the property would be treated as property described in subparagraph 88(1)(c.3)(i) as proposed to be amended, the exchangeable shares and ancillary rights should be considered to have an aggregate fair market value equal to the fair market value of the shares for which they would be exchanged on the date they are acquired. This would be consistent with our suggested approach to the shares of the non-resident corporation issued at the time control of the subsidiary is acquired.

(c) <u>Grandfathering</u>

Finally, given historical uncertainty regarding the application of the "bump denial" rules, and the obvious potential for technical non-compliance due to the breadth of existing subparagraph 88(1)(c.3)(i), we suggest that consideration should be given to having this amendment apply retroactively as described in subsection 18(13) of the Legislative Proposals. Such a change would significantly reduce uncertainty related to past transactions and there does not appear to be any reason to limit the relief to windings-up that commence, and amalgamations that occur, on or after December 21, 2012.

<u>Recommendation</u>:

We recommend that proposed subparagraph 88(1)(c.3)(i) be amended so that:

(i) the 10% fair market value limitation need not be satisfied at all times following the acquisition of control but instead need be satisfied only at the later of the time that is immediately following the acquisition of control and the time at which the property is acquired;

(ii) if the property described in subparagraph 88(1)(c.3)(i) includes exchangeable shares and typical ancillary rights, for purposes of subparagraph 88(1)(c)(i), the exchangeable shares will be treated as if, on the date they were acquired, they had been exchanged for the underlying shares and cancelled and the ancillary rights will be treated as if they did not exist;

(iii) an appropriate anti-avoidance rule be introduced to preclude abuses of the 10% safe harbour;

(iv) the effective date of the amendment be changed to correspond to the effective date for the amendments to paragraphs 88(1)(c.2) and (c.4).

4. Subparagraph 88(1)(c.4)(ii)

The proposed amendment to subparagraph 88(1)(c.4)(ii) will permit a bidder to borrow money to finance the acquisition of a target corporation without having to be concerned about whether the lenders or any of their related corporations were shareholders of the target. This is a very welcome change. However, where the "bump" is effected by an amalgamation of the parent and subsidiary, so that debt of a predecessor becomes debt of the amalgamated corporation, it is not clear that the debt of the parent will continue to qualify as specified property or that debt of a subsidiary will not become substituted property.

Consider the example where the subsidiary has outstanding indebtedness issued in consideration for property acquired by the subsidiary several years before the parent acquires control of the subsidiary. The issuance of the debt was completed in a transaction entirely unrelated to the acquisition of the subsidiary by the parent. On an amalgamation of the parent and the subsidiary, the debt will become debt of the amalgamated corporation. Where the debt is capital property to the debtholder, subsection 87(6), which applies notwithstanding subsection 87(7), provides that in these circumstances the holder of the debt is deemed to have disposed of the debt of the subsidiary and to have acquired the debt of the amalgamated corporation. Because the amalgamation will be part of the series of transactions that includes parent's acquisition of control of the subsidiary, by virtue of the amalgamation and subsection 87(6), the subsidiary's creditors will be deemed to have acquired debt that derives at least part of its value from property of the subsidiary that became property of the amalgamated entity. However, such debt will not have been issued by the parent as consideration for shares of the subsidiary or issued for consideration that consists solely of money. We observe that the same issue may arise on a winding-up of the subsidiary where the parent assumes the subsidiary’s debt. By virtue of paragraph 88(1)(e.2), subsection 87(6) is made applicable to the substitution of the parent’s obligation for that of the subsidiary.)

A similar issue may arise on an amalgamation of the subsidiary and a newly-created subsidiary of the parent where the purpose of the amalgamation is to complete a takeover (i.e., to "squeeze out" a minority where less than all of the shares of the target are acquired). It is possible that the subsidiary's debt holders may include persons who were shareholders, or were related to shareholders, of the subsidiary before the parent's acquisition of control.

Finally, there is a concern that the same issue arises where debt incurred by the parent to fund the acquisition of the shares of the subsidiary becomes debt of the amalgamated corporation where the parent and subsidiary amalgamate.

We observe that the same concern might arise in the context of shares issued by the parent (or another corporation) which are specified property but, on an amalgamation, might be considered to have been exchanged for shares of the amalgamated corporation so that they can no longer be considered to have been received as consideration for the acquisition of a share of the subsidiary and therefor cease to qualify as specified property. In this regard, we acknowledge that subsection 88(4) deems a corporation created by an amalgamation to be the same corporation as, and a continuation of, each predecessor corporation for purposes of paragraph 88(1)(c.4). However, it does not state that the securities issued by the amalgamated corporation are to be treated a continuation of and the same securities as the securities of the predecessor for which they are exchanged. For example, see the approach taken in subsections 87(4.1) to (4.5). While we understand that CRA interprets subsection 88(4) as addressing this issue, we believe it should be addressed specifically in the legislation and recommend that subsection 88(4) be amended so that any share or right to acquire a share of the amalgamated corporation (a “new security”) acquired on an amalgamation in exchange for a share or right to acquire a share of a predecessor corporation (the “old security”) be treated as the same security as and a continuation of the old security, provided the terms and conditions of the new security are the same as, or substantially the same as the terms and conditions of the old security. This is the same standard as is used in subsections 87(4.1) to (4.5).

<u>Recommendation</u>:

We recommend that subparagraph 88(1)(c.4)(ii) be expanded to include:

(a) debt issued on an amalgamation where the debt for which it is substituted on the amalgamation either

(i) qualified as debt described in proposed clauses 88(1)(c.4)(ii)(A) or (B) or

(ii) was debt issued by a predecessor, otherwise than as part of the series of transactions that includes the acquisition of control of the subsidiary by the parent, where the conditions of subsection 87(6) would apply to that substitution if the predecessor debt was held by the holder as capital property; and

(b) debt issued by the parent as a result of the parent’s assumption, on the winding-up of the subsidiary, of debt issued by the subsidiary, otherwise than as part of the series of transactions that includes the acquisition of control of the subsidiary by the parent, where the conditions of subsection 87(6), as modified by paragraph 88(1)(e.2), would apply to the acquisition of the debt issued by the parent if the debt issued by the subsidiary was held by the holder as capital property.

We also recommend that subsection 88(4) be amended to clarify that, for purposes of paragraph 88(1)(c.4), any share or right to acquire a share of the amalgamated corporation (a “new security”) acquired on an amalgamation in exchange for a share or right to acquire a share of a predecessor corporation (the “old security”) be treated as the same security as, and a continuation of, the old security provided that the terms and conditions of the new security are the same as, or substantially the same, as the terms and conditions of the old security for which they were exchanged.

5. Subparagraph 88(1)(c.4)(v)

Proposed subparagraph 88(1)(c.4)(vi) will combine and amend existing subparagraphs 88(1)(c.4)(v) and (vi) and is intended to address issues raised in various comfort letters issued by the Department concerning the scope of the definition of specified property. Proposed clause (A) addresses shares issued by the subsidiary on an amalgamation which may be necessary to complete a takeover (i.e., to "squeeze out" a minority). However, in our view, clause (A) does not adequately address all of the relevant situations.

Firstly, subclause (A)(I) requires a share issued by the subsidiary on the amalgamation to be redeemed, acquired or cancelled by the subsidiary solely for money. However, the comfort letter dated May 2, 2002 contemplates that the shares of the subsidiary issued on the amalgamation might be redeemed for shares of the parent. While subclause (A)(II) permits shares to be exchanged for shares of the parent, if the exchange takes the form of a redemption, purchase or cancellation by the subsidiary (in contrast to an exchange with the parent itself), it may be uncertain whether the shares of the subsidiary qualify. They will have been redeemed, acquired and cancelled by the subsidiary but not solely for money and, read in the context of the two provisions, subclause (II) may be interpreted as addressing only circumstances where the share is not redeemed, acquired or cancelled by the subsidiary (i.e., so that an exchange requires the property exchanged to continue to exist).

Secondly, the comfort letter of January 20, 2006 contemplates that the shares of the subsidiary issued on the amalgamation might be redeemed by the subsidiary for a combination of shares and money. The proposed amendment would not seem to accommodate such a redemption. Notwithstanding that "share" is defined for purposes of the Act to include a fraction of a share, where the subsidiary's shares are redeemable by their terms for a combination of cash and shares of the parent, one cannot conclude that a fraction of the share is redeemed solely for money and a fraction of the share is exchanged for a parent share. Section 85.1 provides for an automatic rollover where a share of a purchaser corporation is issued in exchange for a share of another corporation and certain conditions are satisfied. One of those conditions is that no consideration other than shares of the purchaser is received in exchange for the acquired shares. We observe that CRA's position is that, in circumstances where the consideration to be received for a share includes cash and shares of the purchaser, section 85.1 will not apply unless "the purchaser's offer clearly indicates that the share consideration will be exchanged for a specified fraction of each share tendered and the non-share consideration will be given for the remaining fraction": Interpretation Bulletin IT-450R To be consistent, CRA would have to take the same position with respect to this provision. While in the case of section 85.1 CRA's position can be accommodated in planning a transaction, paragraph 88(1)(c.4)(v) is intended to apply to windings-up that begin, and amalgamations that occur, after 2001. Transactions may have already occurred that relied on the terms of the comfort letter.

Recommendation:

We recommend that proposed clause 88(1)(c.4)(A) be revised to read as follows:

> (A) a share of the capital stock of the subsidiary that was issued on the amalgamation and that is, before the commencement of the winding-up,
>
> > (I) redeemed, acquired or cancelled by the subsidiary for consideration that consists solely of money, shares of the capital stock of the parent, or any combination of money and shares of the capital stock of the parent, or
> >
> > (II) otherwise exchanged for shares of the capital stock of the parent, or

6. Subparagraph 88(1)(c.4)(vi)

The proposed amendment to subparagraph 88(1)(c.4)(vi) will apply only for windings-up that begin, and amalgamations that occur, after 2001 and before December 21, 2012 (subject to certain transitional relief until July 2013). The amendment will apply only where shares were issued to a person described in clause 88(1)(c)(vi)(B) and not where such shares were otherwise acquired by such persons. For example, after the shares were issued, they might have been transferred to a holding company, to a spouse or to a child.

Recommendation:

We recommend that proposed subparagraph 88(1)(c.4)(vi) be amended to read as follows:

> (vi) a share of the capital stock of a corporation acquired by a person described in clause (c)(vi)(B) if all the shares...

7. Subparagraph 88(1)(c.9)

Proposed subparagraph 88(1)(c.9) provides that, for purposes of subparagraph 88(1)(c.4), a reference to a share of the capital stock of a corporation is to be read as including a right to acquire a share of the capital stock of that corporation. The stated purpose of the provision is to address the concern addressed in a number of the Department's comfort letters concerning the treatment of options or warrants to acquire shares that would be specified property. Although this approach has the benefit of simplicity, in our view it also raises some potential problems and does not adequately address all the circumstances in which options or warrants present issues.

(a) Employee Stock Options

For example, a stock option on shares of the parent or a related corporation (including a non-resident corporation) granted to an employee of the subsidiary following the acquisition of control should, in our view, be *per se* specified property as long as the option was received in respect of employment (so that the rules in section 7 apply) and is not "in-the-money" when granted (i.e., would, if exercised immediately after it is granted, meet the conditions of paragraph 110(1)(d)). In this regard, we observe that such employee stock options are compensatory and it should not matter whether they are issued in exchange for an option of the subsidiary or are simply issued to the employees as part of their continued employment under the new ownership.

Secondly, in some circumstances, employee stock options of a subsidiary are cancelled by the subsidiary and the parent issues new options in exchange in a transaction that qualifies under subsection 7(1.4). Nonetheless, such a transaction would not be described in subparagraph 88(1)(c.4)(i) as modified by proposed subparagraph 88(1)(c.9) because the replacement option issued by the parent would not be received as consideration for the acquisition of an option of the subsidiary ***by the parent or by a corporation that was a specified subsidiary of the parent immediately before the acquisition.*** The old option is typically surrendered to and cancelled by the subsidiary, and is not acquired by the parent.

Thirdly, employee stock options to acquire shares of the subsidiary may be replaced with options to acquire shares of a foreign corporation of which the parent is a subsidiary. Such an option exchange would not qualify under the proposed amendment because each of subparagraphs 88(1)(c.4)(i), (iii) and (v) apply only where the issuing corporation is a taxable Canadian corporation (i.e., the parent, the subsidiary, or another taxable Canadian corporation that meets certain conditions). Again, these options are compensatory and permitting options issued by the subsidiary to be exchanged for options of the parent in an exchange governed by subsection 7(1.4) is not inconsistent with the policy underlying the "bump denial" rules.

(b) <u>Other Property</u>

Any property owned by a person described in clause 88(1)(c)(vi)(B) (a "prohibited person") after the acquisition of control the fair market value of which is wholly or partly attributable to property distributed to the parent will result in a "bump denial" unless the property is specified property. The phrase "wholly or partly" obviously has very wide scope and would include not only shares and debt (exceptions for which are granted through the definition of specified property) but a guarantee of indebtedness (for example, provided by a foreign parent) that is itself specified property. We believe it is appropriate to expand the exception contemplated by proposed subparagraph 88(1)(c.9) to include such property rights.

Subparagraphs 88(1)(c.3)(vi) and (vii) will exclude from substituted property certain shares provided the conditions outlined in those provisions are met. In our view, rights to acquire shares should also be excluded if similar conditions are met. This could be accomplished by extending the application of proposed paragraph 88(1)(c.9) so that it also applies for purposes of subparagraphs 88(1)(c.3)(vi) and (vii).

Finally, it seems inappropriate to read all references to shares as including rights to acquire shares. In particular, if the second reference to shares in proposed subparagraph 88(1)(c.4)(vi) includes a reference to warrants and options, the requirement would be changed from one where all shares of the subsidiary must be acquired for cash to one where any warrants, options or other rights to acquire shares of the subsidiary (including employee stock options) would also have to be acquired by the parent solely for cash. We assume this apparent limitation is not intended.

<u>Recommendation</u>:

We recommend that proposed paragraph 88(1)(c.9) be amended so that it not apply for purposes of the second reference to shares in subparagraph 88(1)(c.4)(vi) and that its application be extended to subparagraphs 88(c.3)(vi) and (vii).

We also recommend that two additional specific amendments be added to paragraph 88(1)(c.4). The first would be to treat as specified property any agreement to acquire shares described in section 7 (an "employee stock option") and granted or acquired by employees of the parent (or of a corporation related to the parent) provided that paragraph 110(1)(d) would apply if the employee stock option were exercised by the employee immediately following the date it is granted or acquired.

The second would be to treat as specified property any right granted by the parent or any corporation related to the parent where such right is a guarantee of indebtedness that is specified property.

C. Proposed Changes Relating to RRIFs, RRSPs and TFSAs

We very much appreciate your consideration of our submission on the proposals relating to RRIFs, RRSPs and TFSAs that were contained in Bill C-13, dated October 28, 2011, and your written response to that submission. This submission is limited to commenting on certain aspects of the December 21, 2012 proposals and generally will not reiterate any of the broader comments in our prior submission.

1. Swap Transactions

Subsection 33(17) of the Legislative Proposals sets out the coming-into-force ("**CIF**") provisions for amendments to the definition of "swap transaction" in subsection 207.01(1). We believe the intent of these particular proposals and the related CIF provisions associated with the 2011 budget is to preclude a transaction, which is undertaken to remove a prohibited investment or other investment attracting an advantage tax from a RRSP or RRIF prior to 2022, from thereby being considered a swap transaction. In other words, we believe the purpose is to facilitate the removal of such investments from RRSPs and RRIFs.

However, the language used in the December 21, 2012 CIF and 2011 budget CIF provisions could be interpreted as meaning that transactions undertaken to remove "bad properties" from a RRSP or RRIF do not avoid the swap transaction definition even if they occur before 2022. Instead, the CIF provisions can be interpreted as meaning that such transactions become swap transactions when the definition comes into force on January 1, 2022, regardless of when the transactions occur. In other words, the application of the definition (and therefore tax under Part XI.01) arguably "springs" into force on January 1, 2022. We presume this is not intentional.

Another issue arises under the CIF provisions due to the proposed indefinite grandfathering of prohibited investments that qualify for the transitional relieving rules. Unless it is reasonable to conclude that the retention of the property in the RRSP or RRIF would result in tax being payable under Part XI.01, the deferred application of the swap transaction definition is not available. However, if the appropriate steps are taken to qualify for indefinite transitional relief, it may be difficult to conclude that retention of the property would result in tax being payable under Part XI.01.

Moreover, under the existing provisions of the Act, the deferred application of the swap transaction definition for transactions undertaken to remove a "bad property" from a RRSP or RRIF corresponds with the expiration of the transitional relief. Given the proposed indefinite grandfathering of prohibited investments under the Legislative Proposals, it would appear appropriate to also indefinitely extend the exception from the swap transaction definition for transactions that simply remove "bad properties".

Recommendation:

Subsection 33(17) of the Legislative Proposals be amended to read as follows:

> Subsection (11) applies to swap transactions undertaken after June 2011 unless the transaction was undertaken to remove a property from a RRIF or RRSP and it is reasonable to conclude that retention of the property in the RRIF or RRSP would result in a tax being payable under Part X1.01 of the Act without having regard to subsection 207.05(4).

Subsection 64(6) of Bill C-13 be amended as follows:

> Subsections (1) and (2) apply to transactions occurring, income earned, capital gains accruing and investments acquired, after March 22, 2011, except that the definition "swap transaction" in subsection 207.01(1) of the Act, as enacted by subsection (2), applies to swap transactions undertaken after June 2011 unless the transaction was undertaken to remove a property from a RRIF or RRSP and it is reasonable to conclude that retention of the property in the RRIF or RRSP would result in tax being payable under Part X1.01 of the Act without having regard to subsection 207.05(4).

2. Impact of Proposed Subsection 207.01(6) on Transitional Prohibited Investments and Grandfathered Prohibited Investments

Under the Legislative Proposals, if, at any time, a property held by a trust governed by a registered plan becomes, or ceases to be, a prohibited investment or non-qualified investment for the trust, the trust is deemed to have disposed of the property immediately before that time for proceeds of disposition equal to the fair market value of the property at that time and to have re-acquired the property at that time at a cost equal to that fair market value.

It appears that this rule will cause a problem for prohibited investments that qualify for the transitional rule in subsection 207.05(4).

For example, assume that a taxpayer holds 9% of the issued equity of a public company in his RRSP and a related person holds another 9% outside of her RRSP. The taxpayer held the "transitional prohibited investment" on March 22, 2011 and has met the conditions for the subsection 207.05(4) election.

On July 1, 2013, the related person sells her entire interest, such that the taxpayer's interest is no longer a prohibited investment. Under proposed subsection 207.01(6), it appears that the taxpayer will have a deemed gain to the extent that the value on July 1, 2013 exceeds the value on March 22, 2011. To avoid the advantage tax, it also appears that this deemed gain must be withdrawn even though there was no disposition of the RRSP investment (and therefore no source of funds to withdraw).

It also appears that this rule may cause issues for prohibited investments that qualify for grandfathering under the transitional rules in subsection 207.04(1), by virtue of having been acquired prior to March 23, 2011, but then subsequently become non-qualified investments.

For example, assume that on March 23, 2011 a taxpayer holds a qualified investment in his RRSP (e.g., a unit of a mutual fund trust or an investment which is registered, such as a share of the capital stock of a Northwest Territories risk capital investment) which is, on that date, a prohibited investment for the RRSP (i.e., by virtue of the taxpayer having a "significant interest" in the issuer). Under the existing provisions of the Act, if that investment subsequently becomes a non-qualified investment (e.g., by virtue of the trust ceasing to be a mutual fund trust or the revocation of the investment's registration under the relevant legislation), it will continue to have grandfathering from the 50% tax imposed under subsection 207.04(1) on the basis that, pursuant to subsection 207.04(3), it will be deemed not to be a non-qualified investment but will remain a prohibited investment which was acquired prior to March 23, 2011 for the purposes of section 207.04. This result is appropriate given the indefinite grandfathering of prohibited investments.

Proposed subsection 207.01(6) alters this result, which we believe was unintentional. In particular, where a pre-March 23, 2011 prohibited investment subsequently becomes a non-qualified investment, the provision will deem the RRSP to have acquired the investment immediately before the time that it became a non-qualified investment. Accordingly, the requirements for grandfathering will no longer be satisfied since the investment will be deemed to have been acquired after March 23, 2011, through no action of the taxpayer or the RRSP. Because subsection 207.04(3) (which would deem the investment not to be a non-qualified but to continue to be prohibited) does not explicitly apply for the purposes of proposed subsection 207.01(6), that provision is insufficient, in and of itself, to remediate the issue.

Recommendation:

Proposed subsection 207.01(6) should be amended so that there will not be a deemed disposition of the “transitional prohibited investment” in the example if that investment ceases to be a prohibited investment. The recognition of the post-budget gain, measured at the time the investment ceases to be a prohibited investment, should be deferred until there is an actual disposition of the investment.

In particular, in the example provided, the amount that needs to be withdrawn from the RRSP at the time of an actual disposition to avoid the advantage tax should be the amount of the gain at that time, to the extent that the gain arose between March 22, 2011 and July 1, 2013 (the stub period). If there is no appreciation from March 22, 2011 to the date of sale, then no amount needs to be withdrawn. If the gain accruing after March 22, 2011 to the date of sale is lower than the stub period gain, then only the gain from March 22, 2011 to the date of sale needs to be withdrawn.

In addition, proposed subsection 207.01(6) should not apply where a property that is a prohibited investment subsequently becomes a non-qualified investment. Subsection 207.04(3) should be amended so that it explicitly applies for the purposes of proposed subsection 207.01(6).

3. Deemed March 23, 2011 Cost

Proposed subsection 207.01(7) provides a deemed adjusted cost base ("**ACB**") rule for properties that were held in a RRSP or RRIF when the Part XI.01 rules were extended to those plans effective March 23, 2011. Specifically, the proposed rule deems the fair market value of the property on March 23, 2011 to be the property's cost, for purposes of computing its ACB.

It is possible that a RRSP or RRIF may hold property that is not capital property for purposes of the Act. It also is possible that the ACB of capital property may differ from its cost, and change over time.

Recommendation:

We recommend that proposed subsection 207.01(7) be amended to apply for purposes of computing a RRSP's or RRIF's income or capital gains (as opposed to ACB), and that it deem such property to be acquired on March 22, 2011 at a cost equal to its fair market value on that date.

4. Prohibited Investments

The Legislative Proposals eliminate the phrase "or with a person or partnership described in subparagraph (i)" from subparagraph (b)(ii) of the definition of prohibited investment. The example provided by the technical notes states that if an individual has a small portfolio interest in their RRSP in a corporation that controls a second corporation of which the individual owns 11% of a class of shares, the RRSP investment would, absent this amendment, be a prohibited investment for the individual.

However, the elimination of the above phrase in the Legislative Proposals would not preclude the small portfolio interest of the individual in the example from being a prohibited investment. In the example, the individual owns 11% of the second corporation that is controlled by the first corporation. Since the individual owns 10% or more of the shares of the second corporation, and since that corporation is related to the first corporation by virtue of being controlled by it, the individual is a "specified shareholder" of both corporations, as defined in subsection 248(1). The individual therefore has a significant interest in both corporations pursuant to paragraph 207.01(4)(a).

Given the usage of the exceptionally broad concepts of "specified shareholder" and non-arm's length (as opposed to bright line tests), the proposed narrowing of the prohibited investment definition likely will be of very little practical relief. In particular, that narrowing is unlikely to prevent taxpayers from being subject to Part XI.01 tax in a great many circumstances where, we submit, there is no compelling policy reason for the rules to apply (including in the example provided in the explanatory notes).

Recommendation:

We reiterate our earlier recommendation that the ownership threshold test be based on a clearly defined category of related persons rather than broad non-arm's length and unmodified specified shareholder tests, and that the ownership threshold be increased to a percentage that is low enough to exclude the potential for influence, but does not unduly sweep in portfolio investments. Again, we refer you to the 25% modified "related person" ownership limitations that were created in the context of mortgage investment corporations, since our understanding is that those rules were designed with that purpose in mind and those rules are far more capable of precise application and efficient determination of whether the rules apply.

5. Extension of Deadline to Qualify for Transitional Relief

Subsection 207.05(4) of the Act provides transitional relief from the advantage rules in respect of a "transitional prohibited investment benefit" (as defined in subsection 207.01(1)) if the amount is paid out of the RRSP or RRIF of the taxpayer within 90 days after the end of the relevant taxation year and if an election is filed in prescribed form. In the Legislative Proposals, it is proposed that the deadline for filing this election (currently July 2012) be extended to March 1, 2013 so that taxpayers have time to become aware of the rules and determine whether they are affected by the amendments to Part XI.01.

To qualify for the transitional relief, in addition to electing, taxpayers also must have withdrawn the "transitional prohibited investment benefit" within 90 days of the year to which it relates. Taxpayers who did not elect within the original filing deadline of July 2012 would not have withdrawn amounts within the 90 days in respect of the 2011 year. Consequently, the proposed amendment, while welcome, appears to be of less utility than it could be in respect of transitional prohibited investment benefits for the 2011 year.

In addition, often individuals do not turn their attention to tax returns other than in connection with preparing their personal tax returns, which are due on April 30. There likely will be circumstances where individuals miss the extended election deadline because it does not align with their filing due-date.

As a final observation, particularly in circumstances where an investment is not generating any, or any material, income, and has not been disposed of, there is a heightened risk that individuals will not turn their minds to the prohibited investment rules. Such individuals may fail to qualify for the transitional rules for no reason other than they did not elect within the specified time.

Recommendation:

The deadline for withdrawing the amounts described in subsection 207.05(4) in respect of 2011 should be extended to conform to the extended deadline for making the election.

In addition, the deadline for electing and withdrawing amounts to qualify for transitional relief should conform to the April 30 filing due-date for any particular prior year.

Finally, the deadline for electing should be the later of April 30, 2013 and April 30 of the first year following which the controlling individual has a transitional prohibited investment benefit. Alternatively, the Minister should have discretion to accept a late-filed election under the "fairness" provisions of the Act.

6. Extension of Prohibited Investment Rules to RCAs

Prohibited investment rules were extended to retirement compensation arrangements ("**RCAs**") under Bill C-45. The Legislative Proposals deal with the prohibited investment rules in Part

XI.01 that are applicable to TFSAs, RRSPs and RRIFs. The Legislative Proposals do not contemplate Part XI.3.

Recommendation:

Similar amendments to Part XI.3 should be introduced to conform to the amendments to Part XI.01.

7. Locked-In Accounts

The transitional relief rules, as well as the waiver rules, in Part XI.01 presume that withdrawals from a particular plan are always possible. However, if a plan is "locked-in" that is not the case.

Recommendation:

At a minimum, where Part XI.01 taxes would apply in respect of a particular locked-in plan, withdrawals from another (non-locked-in plan) of the same annuitant should constitute a withdrawal from the particular plan for purposes of the transitional rules and waiver provisions.

In addition, to address circumstances where an annuitant may not have a non-locked-in plan from which to make a withdrawal (or has insufficient value in his or her non-locked in plans to make the necessary withdrawal), we recommend that you work with applicable provincial governments and any other applicable authorities to ensure that the mechanisms contemplated in the Act are capable of being complied with. For example, perhaps provincial governments and other applicable authorities would be amenable to allowing funds to be withdrawn from locked-in plans where Part XI.01 taxes otherwise may reasonably be expected to apply.