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

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October 23, 2007

Mr. Gerard Lalonde, Director
Tax Legislation Division
Tax Policy Branch, Department of Finance
17th Floor, East Tower
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Mr. Lalonde:

October 2, 2007 Draft Legislative Proposals with
respect to the remaining Tax Provisions of Budget 2007

On October 2, 2007, the Minister of Finance released draft legislative proposals to implement the remaining measures proposed in the March 17, 2007 Budget.

As comments on the proposals were requested in the Department of Finance Press Release to be received by today's date we cannot provide extensive comments. There are, however, several matters that have been brought to our attention and we have included them in the enclosed submission.

Please note that this submission is not intended to be exhaustive. As we continue to review these proposals, it is very likely that we will have additional comments. We will be discussing with you the best way to review our comments with you and members of your Department.

In the meantime, we would be happy to discuss the matters contained in this submission.

Yours truly,

Bruce Harris, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Paul Tamaki
Chair, Taxation Committee
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cc: Brian Ernewein – Department of Finance

Submission of the
CICA-CBA Joint Committee on Taxation

October 2, 2007 Draft Legislative Proposals to Implement Remaining Budget 2007 Tax Measures

A. Introduction

This submission comments on several matters relating to the draft legislative proposals to amend the *Income Tax Act* ("Draft Legislation") which were released by the Minister of Finance on October 2, 2007 relating to measures that were proposed in Budget 2007. This submission is not intended to be exhaustive.

B. Costs Referred to in Paragraph 20(1)(e)

The preamble in proposed 18.2(3)(a) provides that a cost referred to in paragraph 20(1)(e) (referred to below as an "issue cost") is included in a corporation's specified financing expense in the year that the cost is *paid or payable*. Since issue costs are deductible under paragraph 20(1)(e) on an amortized basis (generally over 5 years), there is a mismatch between the year in which the issue cost is included as a specified financing expense and the years over which the cost is deducted.

Subsection 18.2(9) provides that members of a partnership may be required to include in their income their specified proportion of issue costs paid or payable by the partnership. Because of the use of the words "paid or payable" in subsection 18.2(9), the timing of this addition into income is not on the same basis as the related deductions are claimed by the partnership under paragraph 20(1)(e).

Subsection 3(2) of the draft Bill to implement the Draft Legislation provides that proposed section 18.2 of the Act will apply in respect of interest paid or payable in respect of a period or periods that begin after 2011. There is no reference to issue costs.

Recommendation:

We recommend that there be a matching between the inclusion of an issue cost under subparagraph 18.2(3)(a)(ii) and subsection 18.2(9) and the deductibility of the related amount under paragraph 20(1)(e).

We also recommend that the coming into force provision should refer to issue costs.

C. The Concept of "Substituted Property" in Subparagraph 18.2(3)(a)(ii)

Proposed subparagraph 18.2(3)(a)(ii) of the Act provides that one of the elements in determining a particular corporation's specified financing expense in respect of an inter-affiliate loan for a taxation year is the interest paid or payable in the taxation year by the particular corporation on

> an amount payable for property where it is reasonable to consider that the property, or property substituted for it (or, where the property or property substituted for it is a share of the capital stock of a corporation, property of the corporation or of a person related to the corporation, or property substituted for such property) is used, directly or indirectly, for the purpose of funding, in whole or in part, the inter-affiliate loan.

It is evident that the above is intended to cover interest which is deductible under subparagraph 20(1)(c)(ii) of the Act.

Proposed subparagraph 18.2(3)(a)(ii) refers to property *or property substituted for it* when, in contrast, subparagraph 20(1)(c)(ii) does not contain a specific reference to "substituted property."

Administratively, the concept of "substituted property" is read into subparagraph 20(1)(c)(ii). Paragraph 24 of Interpretation Bulletin IT-533 states that, although there is no "use" test in subparagraph 20(1)(c)(ii), if the property is sold, the substituted property would be relevant in determining interest deductibility. This suggests that, although subparagraph 20(1)(c)(ii) does not specifically refer to substituted property, the provision should be interpreted such that, where an amount is payable for property and the property is sold, the "property" referred to in subparagraph 20(1)(c)(ii) is the substituted property. In that case, deductibility of interest under subparagraph 20(1)(c)(ii) would be dependent on the continuing purpose for which the substituted property is acquired and not the purpose for which original property was acquired.

The manner in which substituted property is referred to in subparagraph 18.2(3)(a)(ii) suggests that the original property continues to be relevant in applying the provision even after the original property is disposed of and substituted property is acquired. This introduces uncertainty as to the proper interpretation of subparagraph 20(1)(c)(ii). Other implications of this in applying subparagraph 18.2(3)(a)(ii) are discussed below under the next heading.

Recommendation:

We recommend that the references to "or property substituted for it" in subparagraph 18.2(3)(a)(ii) be deleted and that an explanation of the concept of substituted property be included in the Explanatory Notes only. If the Department of Finance feels that it is necessary to include a reference to substituted property in the legislation itself, we recommend that, instead of including "property substituted for it" in subsection 18.2(3)(a)(ii), a separate section be added to declare that, for greater certainty, for the purposes of applying subparagraph 18.2(3)(a)(ii) after a particular property referred to in either of those subparagraphs is disposed of, the "property" referred to in subparagraph 18.2(3)(a)(ii) is the substituted property, so that thereafter subparagraph 18(3)(a)(ii) refers to only the substituted property. To be consistent, a similar section may also be required for subparagraph 20(1)(c)(ii).

D. PROPOSED SUBPARAGRAPH 18.2(3)(a)(ii) IS UNDULY BROAD

The wording of proposed subparagraph 18.2(3)(a)(ii) is very broad and could give rise to inappropriate results.

We understand that the intended operation of the rule is as set out in Example 3 of the Explanatory Notes to the Draft Legislation which provides:

> **Example 3**
>
> Canco purchases all the shares of Cansub from a third-party in exchange for an interest-bearing note. Immediately following the purchase, Canco [we presume that this is intended to refer to a sale by Cansub] sells all the assets of Cansub for cash and uses the proceeds to fund an inter-affiliate loan.
>
> Although the inter-affiliate loan is funded by the proceeds of disposition from the sale of assets, the shares of the company that owned the assets were acquired by means of the interest-bearing note and so it is reasonable to consider that property of the company was substituted for property that was used to fund the inter-affiliate loan.

Based on the example, we assume that it was concluded that the amount payable for the Cansub shares had a sufficient nexus, both temporally and otherwise, to the property used to make the loan that it was considered appropriate to treat the amount payable by Canco as having been incurred to indirectly fund the inter-affiliate loan.

Because it refers to "an amount payable for property where it is reasonable to consider that the property *or property substituted for it*" is used to fund an inter-affiliate loan, subparagraph 18.2(3)(a)(ii) suggests that if, in the above example, Canco disposes of the acquired property (the shares of Cansub) for cash and uses the cash to fund its Canadian operations, subparagraph 18.2(3)(a)(ii) continues to apply to the interest-bearing note if it is reasonable to conclude that *either* the original property *or* property substituted for it is used for the purpose of funding an inter-affiliate loan. We submit that, in this case (and, as discussed above, consistent with the interpretation of subparagraph 20(1)(c)(ii)), the future application of subparagraph 18.2(3)(a)(ii) should depend on the current purpose for which the substituted property is used. This concern would be addressed if our recommendation under the previous heading is adopted.

There is also a concern with the scope of the parenthetical words in subparagraph 18.2(3)(a)(ii). These words provide that, where the acquired property is shares of a corporation (Cansub), subparagraph 18.2(3)(a)(ii) applies if *property of the corporation or of a person related to the corporation, or any property substituted for such property* is used for the purpose of funding the inter-affiliate loan.

The potential scope of subparagraph 18.2(3)(a)(ii) is far broader than the example used in the Explanatory Notes. For example, there is nothing in the rule itself that limits its application to property of Cansub that was owned by Cansub at the time its shares were acquired by Canco:

> Assume that Canco acquires Cansub in Year 1 for $100 million represented by a note issued to the vendor. No inter-affiliate loan is funded by Cansub at that time. In Year 4, Cansub receives an equity injection from Canco and uses that amount to fund an inter-affiliate loan. In years 1 through 3, no amount is included under subparagraph 18.2(3)(a)(ii). In year 4, however, property of Cansub has been used to fund an inter-affiliate loan.

The requirements of subparagraph (ii) appear to be met – i.e., there is an inter-affiliate loan, there is an "amount payable" for property (the shares of Cansub), and it is reasonable to consider that property of Cansub has been used to fund the inter-affiliate loan. It thus appears that the amount payable by Canco for the Cansub shares would be caught by section 18.2 despite the fact that it is not reasonable to conclude that the amount payable in any way funded, directly, or indirectly, the inter-affiliate loan. It is submitted that this is an inappropriate result.

The reference to property of a "related corporation" being used to fund an inter-affiliate loan also leads to anomalous results. Consider the following example:

> Canco acquires Cansub for an amount payable of $100 million. At the time of its acquisition of Cansub, Canco owns existing Cansub 2, which owns a foreign affiliate operating corporation ("FA Opco"). Cansub 2 uses its retained earnings to indirectly fund an inter-affiliate loan, to FA Opco.

After Cansub 1 is acquired by Canco, it is clearly a corporation related to Cansub 2, although Cansub 2 is a "sister" corporation that was already owned by Canco and was not acquired as part of the acquisition of Cansub 1. However, it appears that subparagraph 18.2(3)(a)(ii) would apply because there is an amount payable by Canco for the shares of Cansub and property of a person related to Cansub (Cansub 2) is used to fund an inter-affiliate loan. This is despite the fact that there is no connection between the "amount payable" for the Cansub shares and the property of Cansub 2 which is used by Cansub 2 to fund an inter-affiliate loan.

Recommendation:

The concern with respect to the method of application of subparagraph 18.2(3)(a)(ii) following an acquisition of substituted property would be addressed if our recommendation under C above is adopted.

It submitted that paragraph 18.2(3)(a)(ii) be reworded so that there is a clear requirement for a nexus between the "amount payable" and the property that is used for the purpose of the funding of the inter-affiliate loan.

E. THE DRAFTING OF SUBSECTION 18.2(9) IS UNCLEAR

The preamble in subsection 18.2(9) refers to a partnership that owns, *directly or indirectly*, a share of a specified corporation in respect of which the partnership has borrowed money or become liable for an amount payable. In the context of this subsection, this reference to *indirect* ownership of a share of a specified corporation is unclear. In *Army and Navy Department Stores (Western) Ltd. v. M.N.R.*, 53 DTC 1185 (S.C.C.) it was held that ownership means direct beneficial ownership, so that a shareholder of a parent corporation cannot be said to "indirectly" own shares of another corporation that are owned by the parent. In other areas of the Act (such as the definition of associated corporations: see paragraphs 256(1.2)(d) to (f) of the Act) there are deeming rules which look through corporations, partnerships and trusts to determine indirect "ownership" of entities down a chain.

It is also unclear when it should be concluded that a partnership has borrowed money "in respect of" a share. "Specified corporation" in respect of a partnership is defined to mean (i) a foreign affiliate of a member of the partnership, (ii) a foreign affiliate of a person with whom the partnership does not deal at arm's length, and (iii) a foreign affiliate of a person that does not deal at arm's length with a member of the partnership. If a partnership owns shares of a Canadian entity which in turn owns the shares of a foreign financing corporation ("Finco") that has made an inter-affiliate loan, it would be reasonable to conclude that Finco is a "specified corporation" in respect of the partnership on the basis that Finco is a foreign affiliate of a person (the Canadian entity) with whom the partnership does not deal at arm's length. Even if it could be said that the partnership "indirectly" owns the shares of Finco in this case, however, it is not clear what nexus is required for the partnership to be said to have borrowed money *in respect of* the Finco shares.

In contrast to other provisions of the Act dealing with the determination of partnership income (such as section 96) subsection 18.2(9) does not specify the taxation year of the members of the partnership in which the amounts referred to in paragraph 18.2(9)(a) are to be included in income (or the amounts referred to in paragraph 18.2(9)(b) re to be deducted).

Where paragraph 18.2(9)(a) applies to a partnership, there is an amount included in the income of each corporation *or partnership* that is a member of the first partnership. This suggests that an amount is included in the income of the second partnership. We expect, however, that it is intended that the amount should be included in the income of the ultimate members of the second partnership. If so, such income inclusion should apply only to the ultimate corporate partners of the partnership and not, for example, to individuals.

Recommendation:

If it is felt necessary to have the concept of indirect ownership (which would presumably look down corporate chains) deeming rules analogous to those in paragraphs 256(1.2)(d) to (f) should be included. The other matters referred to above should also be clarified.

F. SUBSECTION 93.1 SHOULD BE MADE APPLICABLE FOR THE PURPOSES OF SUBSECTION 18.2(10)

Where a partnership directly owns a foreign financing corporation that makes the loan to the foreign operating entity, money borrowed by the partnership may be "in respect of" the shares of the foreign financing corporation. However, unless section 93.1 is modified to extend its application to the rules in subsection 18.2(10), the foreign financing corporation will not be a foreign affiliate of any member of the partnership.

Recommendation:

Subsection 93.1(1) should be extended in its application to subsection 18.2(10).

G. CARVE-OUT PERIODS UNDER PARAGRAPHS 95(2)(f) AND (f.1)

Proposed paragraph 95(2)(f) provides that a foreign affiliate's capital gain or loss from the disposition of property (other than designated taxable Canadian property) does not include the portion thereof that can reasonably be considered to have accrued during the specified period of time set out in paragraph 95(2)(f) (referred to in this submission and in the Explanatory Notes as the "carve-out period"). A similar carve-out period is specified in proposed paragraph 95(2)(f.1) in respect of a foreign affiliate's income or loss from property (other than taxable Canadian property) or a business (other than an active business or a taxable Canadian business).

The carve-out period under both of these paragraphs refers to the period of time during which the property or business was that of a person or partnership that was not a "relevant non-arm's length entity" in respect to the taxpayer, a foreign affiliate of such an entity or a partnership a member of which was such an entity or a foreign affiliate of such an entity. This proposed change is generally effective for taxation years ending after December 20, 2002.

Under the Draft Legislation, a "relevant non-arm's length entity" is defined to include the taxpayer or an entity that does not deal at arm's length with the taxpayer. In comparison, paragraph 95(2)(f), as currently enacted (as well as the previously proposed revisions to that paragraph) and the previously-released draft version of paragraph 95(2)(f.1) both include a carve-out period which is more generous than that which is now proposed. Previously, the carve-out period covered the period of time during which the affiliate was not a *foreign affiliate* of the taxpayer and persons that did not deal at arm's length with taxpayer (and certain other persons).

The more limited scope of the new proposed carve-out is illustrated in the following example:

> An individual, who has never been resident of Canada, owns all of the shares of a non-resident corporation ("Forco") that was incorporated by the individual to hold portfolio investments. The individual becomes resident in

> Canada and, accordingly, Forco becomes a foreign affiliate of the individual at that time. Under the previous version of paragraph 95(2)(f), if Forco subsequently disposes of a capital property (other than excluded property), Forco's foreign accrual property income would not include the portion of Forco's capital gain or loss that could reasonably be considered to have accrued while Forco was not a foreign affiliate – i.e. while the individual was not resident in Canada.

Under the Draft Legislation, the individual would be a "relevant non-arm's length entity" from the time of Forco's incorporation. As a result there would be no exclusion under proposed paragraph 95(2)(f) on a subsequent disposition of Forco's property. The whole of Forco's capital gain or loss would be included in the determination of Forco's foreign accrual property income, including the portion of the gain or loss that accrued while the individual was a non-resident. This is an inappropriate result. It is inconsistent with section 128.1 of the Act, which generally provides that the cost of the individual's property (including the shares of Forco) is deemed to be equal to the fair market value of the property at the time the individual became a resident of Canada. We submit that the same rule should apply to Forco's property.

The inappropriate results under proposed paragraph 95(2)(f) would apply in the above circumstance even if the individual had become resident in Canada before the change to proposed 95(2)(f) was announced on October 2, 2007. These concerns also arise where a taxpayer resident in Canada acquires (or has acquired) the shares of Forco from a non-resident person with whom the taxpayer does not deal at arm's length.

Similar issues arise with respect to proposed paragraph 95(2)(f.1).

Recommendation

We recommend that the carve-out period should not be changed from that which was previously proposed in the February 27, 2004 draft amendments to the Act, subject to the remedial changes discussed in existing Department of Finance comfort letters.

If the Department of Finance feels that a change to the carve-out period is necessary, we submit that such change should not be retroactive. In particular, any proposed narrowing of the carve-out period should not apply to existing foreign affiliates. We recommend that, if the carve-out period is changed as proposed, the change should not apply to affiliates that, on October 2, 2007, were foreign affiliates of a person referred to in existing subparagraph 95(2)(a)(iii) to (iv) or to a partnership described in subparagraph 95(2)(f)(v) as proposed to be amended pursuant to the February 27, 2004 draft amendments, in each case subject to the remedial changes discussed in existing Department of Finance comfort letters.