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

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Brian Ernewein
General Director – Legislation
Tax Policy Branch
Department of Finance
140 O'Connor Street
Ottawa, Ontario
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Dear Mr. Ernewein;

Re: July 14, 2008 Draft Legislation

We are writing to provide you with our comments on the proposed amendments to the *Income Tax Act* (the "Act") which were released by the Minister of Finance on July 14, 2008.

A. <u>SIFT Trust and Partnership Definitions</u>

This portion of our submission comments on the proposed amendments giving effect to the December 20, 2007 Press Release announcing technical amendments to clarify the specified investment flow-through (SIFT) entity tax rules.

1. <u>SIFT Partnerships</u>

Subsection 122.1(1) is amended to add a definition of "excluded subsidiary entity". This proposed definition is relevant for both the definition of "SIFT trust" in subsection 122.1(1) and "SIFT partnership" in subsection 197(1) as both of these definitions are proposed to be amended to exclude an "excluded subsidiary entity". An excluded subsidiary entity is an entity the equity of which is not listed or traded on a stock exchange or other public market and is not held by any person or partnership other than a specified list of persons and partnerships. The definition was added to address concerns that have been raised in respect of the broad definition of "security" in subsection 122.1(1). By virtue of the preamble to this definition, a security of a particular trust or partnership may include a security of an affiliated entity (corporation, trust or partnership) if the security of the affiliated entity constitutes a right to an amount that can reasonably be regarded as all or any part of the capital, of the revenue or of the income of the particular trust or partnership. Concern has been raised that, for example, where a corporation is a majority-interest beneficiary of a particular trust or a majority interest partner of a particular partnership and the shares of the corporation are listed or traded on a stock exchange or other public market, the particular trust or partnership may be considered to be a SIFT. Prior to the proposed amendments, it was questionable whether the definition of "security" was generally broad enough to cover such lower tier trusts and partnerships. In the case of SIFT partnerships, the relief provided by the proposed definition of excluded subsidiary entity is not sufficient.

Many structures for investment in Canadian real estate or resource properties involve the use of partnerships. Under these structures, if a corporation or trust with publicly traded securities has a majority interest in a partnership that owns real estate or resource properties, the partnership may be considered to be a SIFT partnership if the partnership also has individual or non-resident partners. This result may create inappropriate tax consequences that would not have been foreseen or intended at the time the structures were put in place. The SIFT rules were intended to apply only to partnerships that provide public liquidity to their partners and not to purely private arrangements. It does not make sense that the rules should apply to a partnership between a public company and a tax-exempt entity if the public company owns 51% of the partnership, but would not apply to the partnership if the public company's interest was reduced to below 50%.

Recommendation

The definition of "excluded subsidiary entity" should be replaced with two separate definitions, one for an excluded subsidiary trust and another for an excluded subsidiary partnership. The definition of excluded subsidiary trust would follow the current definition of excluded subsidiary entity. The definition of excluded subsidiary partnership should be as follows:

> "excluded subsidiary partnership", for a taxation year, means a partnership none of the equity of which is at any time in the taxation year
>
> (a) listed or traded on a stock exchange or other public market; or
>
> (b) is equity (other than equity owned by a real estate investment trust, a taxable Canadian corporation, a SIFT trust (determined without reference to subsection (2)), a SIFT partnership (determined without reference to subsection 197(8)), an excluded subsidiary trust or an excluded subsidiary partnership) that is convertible into, exchangeable for, or a right to acquire, directly or indirectly, a security that is listed or traded on a stock exchange or other public market.

2. Issues Affecting Securitization Trusts

There are a number of issues under the draft legislation affecting the possible application of the SIFT rules to securitization trusts – i.e., trusts that have no publicly-traded equity and the sole beneficiaries of which are one or more charitable organisations.

(a) Definition of "Publicly-Traded Liability"

Subsection 122.1(1) is amended to add definitions of "publicly-traded liability" and "unaffiliated publicly-traded liability". These proposed definitions are relevant for purposes of a new exception to the definition of "investment". Based on the current drafting of "publicly-traded liability" the exception may not apply in a tiered structure.

Assume a securitization trust has issued regular, non-participating, non-convertible debt that is listed or traded on a stock exchange or other public market. The debt of the trust is "unaffiliated publicly-traded liability" and therefore the trust is not a SIFT. The trust's sole investment is as a limited partner in a privately-held partnership with a taxable Canadian corporation as the general partner. Accordingly, the trust's income from its interest in the partnership is closely matched to the trust's interest expense on its public debt and it could be said that that trust's debt replicates a return on the trust's interest in the privately-held partnership. If so, the publicly-traded debt of the trust would be a "security" of the partnership because it is a right which may reasonably be considered to replicate a return on or the value of an interest in the partnership, as described in paragraph (b) of the definition of "investment" (a "replicating right").

As the trust is neither a SIFT nor an excluded subsidiary entity, the partnership cannot be an "excluded subsidiary entity." Accordingly, the partnership could be a SIFT unless, among other things, the debt of the trust is an unaffiliated publicly-traded liability of the partnership. The definitions of "unaffiliated publicly-traded liability" and "publicly-traded liability" require that the relevant liability be a "security" of the partnership. If the trust is not affiliated with the partnership, a liability of the trust cannot be a "security" of the partnership. Accordingly, the exception for unaffiliated publicly-traded liability does not apply at the partnership level when what potentially "taints" the partnership is a replicating right issued by another entity.

Recommendation

In order to provide parallel treatment at the trust level and the partnership level, the definition of "publicly-traded liability" should be amended as follows:

> "publicly-traded liability" of an entity, means a liability that is a security of the entity or <u>a right which may reasonably be considered to replicate a return on, or the value of, a security of the entity</u>, that is not equity of the entity and that is listed or traded on a stock exchange or other public market."

(b) Debt of a Securitization Trust held by a Majority Interest Beneficiary

Debt of a securitization trust will be "unaffiliated publicly-traded liability" of the trust so long as persons or partnerships not affiliated with the trust hold at least 90% of the total fair market value of all publicly-traded liabilities of the trust. Under section 251.1, a person affiliated with a trust includes a majority interest beneficiary of the trust. Accordingly, if a charitable organization is the beneficiary of a securitization trust, the debt of the securitization trust would not be a unaffiliated publicly-traded liability of the trust if the charitable organization holds more than 10% of the publicly-traded debt of the trust.

Recommendation

In order to provide greater certainty as to the status of securitization trusts, we recommend that the 90% test in the definition of "unaffiliated publicly-traded liability" be extended to cover publicly-traded liabilities of a trust that are held by a majority interest beneficiary or a member of a group of majority interest beneficiaries that is exempt from tax.

(c) Debt of a Securitization Trust held by Another Securitization Trust

Two trusts are "affiliated" under paragraph 251.1(1)(h) if two tests are met:

(1) a "contributor" to one trust ("Trust 1") is affiliated with a contributor to the other trust ("Trust 2"), and

(2) a majority interest beneficiary of Trust 1 is affiliated with a majority interest beneficiary of Trust 2:

For the purposes of the above, a "contributor" is defined in subsection 251.1(3) as including a person who has made a loan to a trust, unless the contributor is arm's length with the trust and the loan is made at a reasonable rate of interest. Accordingly, where a securitization trust issues debt (such as commercial paper) for which no rate or a low rate of interest is stipulated to be payable, the lender could be viewed as a contributor, whether or not it dealt at arm's length with the trust. Since persons are affiliated with themselves (paragraph 251.1(4)(a)) it follows that if two securitization trusts have the same lender at a "non-reasonable" rate, they will comply with test (1). Similarly, since persons are affiliated to themselves, Trust 1 and Trust 2 will comply with test (2) if – as a matter of coincidence or otherwise – they both have the same beneficiary (or majority-interest group of beneficiaries). As a result, Trust 1 and Trust 2 would be affiliated persons in this example.

If Trust 1 and Trust 2 are affiliated, it follows that debt of Trust 2 would not be a unaffiliated publicly- traded liability if Trust 1 holds more than 10% of the publicly-traded debt of Trust 2.

Recommendation

In order to provide greater certainty on the status of securitization trusts, we recommend that item (a) of the definition of "contributor" in subsection 251.1(3) should be amended to refer to a debt issued at a reasonable rate of interest or a reasonable yield expressed as a rate of interest.

B. SIFT Conversion Provisions

While the draft legislation reflects many of the recommendations that were made by our Committee in our submissions dated December 4, 2007 and June 18, 2008, certain other matters raised in our submissions were either not addressed or only partially addressed. In particular, we note that the draft legislation contemplates two methods of converting a SIFT trust to a corporation – either:

(1) by way of an acquisition of SIFT units by a corporation on a tax-deferred basis using the rollover in proposed subsection 85.1(8) followed by a winding-up of the acquired entity into the acquiring corporation under either proposed section 88.1 or subsection 107(3.1), or

(2) by way of a distribution of shares of a corporation to SIFT unitholders on the winding-up of the SIFT trust and the redemption of the SIFT units under proposed subsection 107(3.1).

In a number of areas, the tax consequences of a conversion are different, depending on which method of conversion is followed. In principle, we think that the tax consequences of a conversion should be the same, regardless of the method of conversion. In particular,

(a) Part XIII.2 should not apply in respect of a redemption of a trust's units held by a non-resident. Under the draft rules, Part XIII.2 could apply to a distribution to which subsection 107(3.1) applies. We submit that Part XIII.2 should not apply on the redemption of any trust units.

(b) The tax attributes of a trust should be transferable to the continuing corporation under either method of conversion. Pursuant to proposed subsection 107(3.1) it appears that the tax attributes of the SIFT trust will not be transferable to the corporation in anticipation of the share distribution. This deficiency is of particular consequence to resource trusts.

(c) The SIFT conversion rules include a rollover for holders of the debt obligations of a converting trust that are assumed by a taxable Canadian corporation. In the context of a subsection 107(3.1) share distribution, no such relief is available to holders of debt obligations issued by the SIFT trust that are assumed by the taxable Canadian corporation whose shares are distributed.

(d) Amendments should address potential debt forgiveness issues that can arise, *inter alia*, where debt of a corporation or subsidiary trust is capitalised or extinguished. Such relief has been provided in the context of section 88.1 and under subsection 80.01(5), but not in the context of a subsection 107(3.1) SIFT trust wind-up event.

In addition, we have the following comments on the draft legislation.

1. <u>Subsections 85.1(7) and (8)</u>

The current drafting in subsection 85.1(7) is ambiguous and requires clarification.

The requirement in subparagraph 85.1(7)(b)(i) is unclear. Paragraph (a) effectively requires the corporation to own 100% of the equity of the SIFT wind-up entity at the end of the 60 day period; accordingly a statement of that requirement in (b)(i) seems redundant. A sale by a taxpayer of part of his interest in the market before or during the exchange period should not affect his eligibility for a tax-deferred exchange of his remaining interest for shares during the exchange period. We submit that subparagraph 85.1(7)(b)(i) should be removed.

The policy rationale for the fair market value requirement in clause 85.1(7)(b)(ii)(B) is uncertain. In practical terms it may be difficult for a SIFT that converts into a publicly listed corporation under subsection 85.1(8) to know whether this fair market value requirement is met. To the extent that clause 85.1(7)(b)(ii)(B) is intended to guard against the shifting of value as between holders of SIFT equity and the corporation or its shareholders, we submit that this should be addressed in a rule similar to paragraph 85(1)(e.2).

Recommendation

We recommend that subsection 85.1(7) and (8) be more closely aligned with current section 85.1 in respect of share for share exchanges. In particular,

(a) It is unclear why the permitted consideration for a particular disposition of a particular unit is restricted to shares of a single class. We recommend that, like subsection 85.1(2)(d), subsection 85.1(8) should provide for a rollover where a taxpayer disposes of part of its holding in the SIFT wind-up entity for shares of one class (and no other consideration) and another part of its holding for shares of another class (and no other consideration).

(b) As a result of paragraph 85.1(8)(a), subsections 85(1) and (2) will not apply to a particular disposition where the conditions of subsection 85.1(7) are met in respect of that disposition. The ordering of the provisions in this manner can lead to unexpected results for taxpayers disposing of an interest in a trust or partnership. To address this concern, we recommend that the ordering of the provisions be reversed such that subsection 85.1(8) will not apply where the taxpayer and the corporation have filed an election under subsection 85(1) or (2) with respect to the particular disposition.

(c) Current section 85.1 permits a loss to be recognised on a share for share exchange, whereas proposed subsection 85.1(8) would not. As a result, either conversion transactions will require more steps (and thus become more complex) in order to allow unitholders to recognise a loss, or unitholders will be required to dispose of their units in the market. To address these concerns, we recommend that paragraph 85.1(8)(b) not apply where the taxpayer has included any portion of the gain or loss from the disposition of the particular unit in the taxpayer's return for the taxation year in which the exchange occurs.

2. <u>Subsection 85.1(8) - SIFT Partnership units</u>

Pursuant to subparagraph 85.1(7)(b)(ii), the tax-deferred rollover under subsection 85.1(8) will not be available if a holder of a unit of a SIFT partnership receives cash or other non-share consideration in exchange for his unit. In addition, pursuant to paragraph 85.1(8)(c), a share issued on an exchange is deemed to be taxable Canadian property if the unit in exchange for which it was issued was taxable Canadian property.

A unit of a SIFT trust will generally be “excluded property” by virtue of subsection 116(6) such that upon an exchange of units of a SIFT trust for shares of a corporation, the corporation will not be required to make reasonable inquiry as to the residency status of the unitholder or comply with the requirements of subsection 116(5).

In the case of a publicly listed SIFT partnership, a corporation acquiring SIFT partnership units in exchange for shares of the corporation will be required to make reasonable inquiry as to the residency status of the unitholder at that time, and, as the case may be, comply with subsection 116(5) in order to avoid potential liability.

Generally, we believe that listed limited partnership units should not be subject to the compliance requirements of section 116. As an exchange of units for shares under subsection 85.1(8) is likely to be effected under a plan of arrangement under the relevant corporate statute, compliance with the notice requirements and obligations imposed on the acquiring corporation is impractical, particularly given that the partnership unit will be exchanged solely for shares where subsection 85.1(8) applies. The deeming provision in paragraph 85.1(8)(c) will ensure that the “taxable Canadian property” status of the shares received on the exchange is preserved in respect of a non-resident unitholder.

Recommendation

In order to streamline the reorganisation of SIFT partnerships into corporations, we recommend an amendment to subsection 116(6) to treat a limited partnership unit that is listed on a recognised stock exchange, as “excluded property”. At a minimum, we suggest that equity in a SIFT wind-up entity that is a partnership, that is listed on a recognised stock exchange, should be “excluded property”.

3. <u>“SIFT trust wind-up event” and paragraph 88.1(1)(b)</u>

The definition of “SIFT trust wind-up event” and paragraph 88.1(1)(b) determine which trusts will be eligible to distribute property on a tax-deferred basis under the new rules in subsections 107(3.1) and 88.1(2) respectively. The only trusts that currently qualify in addition to SIFT trusts and REITs are trusts the only beneficiary of which was, from July 14, 2008, a SIFT trust, a REIT or a SIFT partnership (to be defined in subsection 248(1) as a “SIFT wind-up entity”). This definition prevents third- or lower-tier trusts from qualifying for a tax-deferred wind-up under subsection 88.1(2) and 107(3.1). It also prevents a lower-tier trust from qualifying if it is indirectly held through subsidiary partnerships or corporations or if it has had more than one beneficiary at any time after July 14, 2008 – for example, where interests in the lower-tier trust are partly-held by a SIFT trust and the rest is held by a subsidiary entity.

Recommendation

We recommend that the class of trusts eligible to make a tax-deferred distribution under either subsection 88.1(2) or 107(3.1) be broadened to include third and lower-tier trusts and trusts the sole beneficiaries of which are one or more corporations, trusts or partnerships that are directly or indirectly wholly-owned by a SIFT wind-up entity.

4. Subsection 88.1(2) and paragraph 88(1)(b)

Proposed paragraph 85.1(8) deems the cost to the corporation of the trust units acquired pursuant to a unit for share exchange to be the lesser of the unit's fair market value and the paid-up capital in respect of the exchanged unit, as determined by variable B in the formula set out in paragraph 85.1(8)(e). If the fair market value of the exchanged unit is less than its undistributed capital immediately before a distribution to which subsection 88.1(2) applies, paragraph 88(1)(b) will deem the corporation to realise a capital gain on the disposition of the trust units.

We submit that there is no policy reason why a capital gain should be realized on the winding-up of a corporation into its sole shareholder under existing section 88 or on a winding-up of a trust into its sole beneficiary under proposed section 88.1. In the case of the winding-up of a wholly-owned corporate subsidiary, the application of paragraph 88(1)(b) can be prevented by a reduction of paid-up capital (without distribution) immediately before the winding-up. The Canada Revenue Agency has ruled that proceeding in this manner solely to avoid the effects of paragraph 88(1)(b) is not subject to GAAR[1]. There does not appear to be any analogous procedure available to a trust in order to avoid an adverse result for the corporate shareholder in a SIFT trust wind-up event under section 88.1.

Recommendation

We recommend that paragraph 88(1)(b) be modified to provide that the shares of the capital stock of the subsidiary (either a corporation or trust) owned by the parent immediately before the winding-up are deemed to have been disposed of by the parent on the winding up for proceeds equal to the total of all amounts each of which is an amount in respect of a share of the capital stock of the subsidiary equal to the adjusted cost base to the parent of the share immediately before the winding-up. If, contrary to our submission, you feel that it is appropriate to continue to have existing paragraph 88(1)(b) apply on a winding-up of a corporation, subsection 88.1(2) should be modified so as to provide that paragraph 88(1)(b) applies as if it read that such shares are disposed of for proceeds equal to the amount described in subparagraph 88(1)(b)(ii).

[1] See CRA document 2006-0196011C6.

5. Section 88.1

Paragraph 88.1(2)(g) provides that subsections 88(1) to (1.7) and section 87 will apply to a trust's distribution of property as if the acquiring corporation last acquired control of the trust described in paragraph 88.1(1)(b) and of each corporation controlled by such a trust when the corporation last became a majority interest beneficiary of the trust. As a result, if all of the units of a trust are acquired by a corporation in the first step of a conversion, there would be a deemed acquisition of control of the trust (and its corporate subsidiaries) as a result of this step. Accordingly, any net capital losses and non-capital losses from property of a trust described in paragraph 88.1(1)(b) or corporations controlled by such a trust will not be deductible by the parent corporation.

Recommendation

In applying section 88.2, an acquisition of control should be deemed not to occur for the purposes of subsections 88(1.1) and 88(1.2) where, as part of the same series of transaction which includes the wind-up distribution, (i) no person (other than the acquiring corporation) became a majority interest beneficiary (or majority interest partner, as applicable) of the SIFT wind-up entity, and (ii) if all the shares of the acquiring corporation that were acquired by taxpayers were acquired by one person, the person would control the acquiring corporation.

6. The Interaction Between section 88.1, and subsections 107(2.1) and 107(3.1)

Subsection 107(2.1) is amended to provide that it does not apply where the rules in subsection (3.1) applies. Where a corporation has acquired all of the units of an income fund on a fully-taxable basis, it may be desirable to wind-up the trust on a taxable basis and have existing subsection 107(2.1) apply. We submit that the draft legislation should be amended to continue to permit this.

Also, while it is specifically provided that subsection 107(3.1) does not apply to a trust distribution if section 88.1 applies, there is nothing which provides that subsection 107(2.1) does not apply to a distribution from the SIFT trust to which section 88.1 applies.

Recommendation

We recommend that both subsections 88.1(2) and 107(3.1) should apply on an elective basis only.

We also recommend that subsection 107(2.1) be amended to provide that it does not apply where the rules in section 88.1 apply to the distribution.

7. Acquisition of control

Where, pursuant to section 88.1, a SIFT wind-up entity distributes shares of a taxable Canadian corporation ("subsidiary") controlled by the SIFT wind-up entity to a corporation that has acquired units of the SIFT wind-up entity in circumstances where subsection 85.1(8) has applied, *de jure* control of the subsidiary passes from the trustees of the SIFT wind-up entity to the acquiring corporation. We note that if a conversion is effected by a SIFT wind-up entity distributing shares of a taxable Canadian corporation to its former unitholders pursuant to subsection 107(3.1), there will not be an acquisition of control (assuming that there is no controlling group). We submit that taxpayers should not be forced to forego the benefit of the continuity rules under section 88.1 in order to avoid an acquisition of control.

Where a SIFT wind-up entity distributes shares of a subsidiary to a taxable Canadian corporation which is its sole beneficiary pursuant to subsection 107(3.1) in circumstances where subsection 85.1(8) has applied, *de jure* control of the subsidiary will pass from the trustees of the SIFT wind-up entity to the acquiring corporation. We submit that there should be no acquisition of control of SIFT subsidiary corporations in such circumstances

We note that the same concerns will arise in the case of a SIFT partnership that holds shares of a subsidiary where the general partner of the SIFT partnership controls the subsidiary. The distribution of shares of such subsidiary corporations to an acquiring corporation on the wind-up of the SIFT partnership in circumstances were subsection 85.1(8) has applied should not result in an acquisition of control of the subsidiary.

Recommendation

We recommend that subsection 256(7) be amended to deem control of SIFT subsidiary entities not to be acquired where, as part of the same series of transaction which includes the wind-up distribution, (i) no person (other than the acquiring corporation) became a majority interest beneficiary (or majority interest partner, as applicable) of the SIFT wind-up entity, and (ii) if all the shares of the acquiring corporation that were acquired by taxpayers were acquired by one person, the person would control the acquiring corporation.

8. Definition of «capitaux propres» -section 122.1(1)

The french version of the definition of "equity" in section 122.1, as currently drafted, suggests that the listed items are property of the entity in question. We suggest that the part of the definition preceding paragraph (a) be modified to read " «capitaux propres» Sont des capitaux propres d'une entité:"

C. Foreign Currency Debt on Acquisition of Control

1. Debt Obligations on Income Account

A "foreign currency debt" is defined in proposed subsection 111(8) as any debt obligation denominated in a currency of a country other than Canada. Proposed subsection 111(12) provides that, for the purposes of existing subsection 111(4), where a corporation owes a foreign currency debt at any time, the corporation is deemed to own at the time that is immediately before that time a property with an adjusted cost base and fair market value determined based on the formula set out in subsection 111(12). It is uncertain whether these provisions apply to debt of a taxpayer which is on income account. As worded, the definition of foreign currency debt could apply to a debt obligation of a taxpayer which is on either income or capital account. Since the deemed property under subsection 111(12) is given an adjusted cost base, the implication is that the deemed property is a capital property regardless of whether the related debt is on income or capital account.

Recommendation

The application of subsection 111(12) to debt owing on income account should be clarified. We submit that the provision should not apply to debt which on income account.

2. Multiple Advances under a Single Debt Obligation

Under paragraph 111(12)(b), the fair market value of the deemed property is based on the total principal amount of the foreign currency debt using the exchange rate applicable at the time of the original borrowing. Paragraph (b) does not apply appropriately where there have been multiple advances and/or repayments under a single debt (such as a line of credit). It is unrealistic to view each advance as a separate debt, especially where there have also been multiple repayments of the debt.

Recommendation

The method of determining the fair market value of the deemed property under paragraph 111(12)(b) should be revised to deal with multiple advances and repayments of a single debt.

3. Subsection 111(13)

The meaning of the words "but for this subsection" in paragraph 111(13)(a) is unclear. This wording suggests that subsection 111(13) prevents a corporation from realizing a gain or loss under some circumstances. This is not the effect of the subsection as it only operates to deem a separate foreign currency debt of a corporation.

4. Functional Currency Reporting

It appears that the proposed amendments to section 111 do not apply appropriately where a taxpayer has made a functional currency election under section 261. Where the taxpayer has made a functional currency election, the proposed rules should apply with reference to the elected functional currency and the currency in which the debt is denominated. For example, the proposed rules should not apply to debt in the same foreign currency as the elected functional currency and should apply to Canadian currency debt if there is an elected functional currency.

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We would be pleased to meet with you to discuss any of the issues discussed in this submission.

Yours truly,

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