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

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September 27, 2010

Mr. Brian Ernewein
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Department of Finance
L'Esplanade, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G5

Re: August 27, 2010 Draft Legislation re: 2010 Budget Proposals and other Previously Announced Initiatives ("Draft Legislation")

Dear Mr. Ernewein,

We are pleased to provide you with our submission on the Draft Legislation. The Draft Legislation incorporates revisions to previously announced income tax measures on which the Joint Committee had made submissions earlier this year. We are pleased that a number of our concerns and recommendations have been addressed.

We wish to commend the Department of Finance on the level of detail and the examples included in the Explanatory Notes in respect of certain measures. In particular, the commentary on the proposed non-resident trust measures and the proposed information reporting regime, has been helpful in our review of the Draft Legislation and in formulating our recommendations for change or clarification. We also commend the Department on the collaborative process that was used for the non-resident trust measures. Members of the Joint Committee have been pleased to participate in this process and we hope the same process will continue to be used for legislative initiatives that involve significant tax changes.

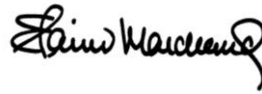
As a general observation, we found the one month consultation period fairly short, particularly in view of the fact that the Explanatory Notes were only released on September 10, 2010. While we have endeavoured to comply with this deadline, we were unable to finalise our comments on certain measures. Accordingly, we will be forwarding an addendum to our submission later this week in respect of measures not addressed in the attached submission. Several members of the Joint Committee participated in discussions concerning our submission and contributed to its preparation, in particular:

Bruce Ball
Bruce Harris
Elaine Marchand
Janice Russell
Mitchell Sherman
Paul Tamaki
Penny Woolford

We trust you will find our comments helpful. As always, members of the Joint Committee would be pleased to meet with you to discuss our submission further at your convenience.

Yours very truly,

D. Bruce Ball
Chair, Taxation Committee
Canadian Institute of Chartered Accountants



Elaine Marchand
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**Submission of the Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants regarding the August 27, 2010 Draft Legislation**

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 the August 27, 2010 Draft Legislation Implementing Remaining 2010 Budget Measures and Other Previously Announced Income Tax Measures.

The following abbreviations are used throughout this submission:

| | |
|---|---|
| Act | *Income Tax Act* |
| Budget | The March 4, 2010 Federal Budget, including Annex 5, Supplementary Information and Notices of Ways and Means Motions |
| Draft Legislation | The August 27, 2010 Draft Legislation Implementing Remaining 2010 Budget Measures and Other Previously Announced Income Tax Measures |
| exempt foreign trust | An "exempt foreign trust" as defined in subsection 94(1) of the Draft Legislation |
| Explanatory Notes | The September 2010 Explanatory Notes in respect of Legislative Proposals Relating to the Income Tax Act and Related Acts and Regulations |
| ITCIA | *Income Tax Conventions Interpretations Act* |
| non-resident portion | The "non-resident portion" of a non-resident trust as defined in section 94 of the Draft Legislation |
| NRT | Non-resident trust which is deemed to be resident in Canada under the Draft Legislation |
| Previous Budget Submission | Our letter dated May 3, 2010 to Mr. Brian Ernewein of the Department of Finance in respect of the Budget |
| Previous Foreign Affiliate Submission | Our letter dated February 15, 2010 to Mr. Brian Ernewein of the Department of Finance in respect of the December 18, 2009 foreign affiliate proposals |
| Previous Information Reporting Submission | Our letter dated July 6, 2010 to Mr. Brian Ernewein of the Department of Finance in respect of the May 7, 2010 Backgrounder on Information Reporting |
| Previous NRT Submission | Our letter dated May 3, 2010 to Mr. Brian Ernewein of the Department of Finance in respect of the proposals on non-resident trusts and foreign investment entities contained in the Budget |
| resident portion | The "resident portion" of a non-resident trust as defined in section 94 of the Draft Legislation. |

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the Act as proposed to be amended under the Draft Legislation.

# I. AMENDMENTS IN RESPECT OF NON-RESIDENT TRUSTS AND OFFSHORE INVESTMENT FUNDS

In our Previous NRT Submission we provided our comments on the March 4, 2010 Budget Proposals with respect to the proposed non-resident trust, foreign investment entity and offshore investment trust provisions contained in the Budget. We are pleased that a number of the concerns that we raised in our Previous NRT Submission have been incorporated into the Draft Legislation and Explanatory Notes. We also commend the Minister of Finance and his officials for the work that they have undertaken on these matters and the collaborative process in which it was carried out. Members of the Joint Committee have been pleased to participate in this process.

As set out in detail below, we have a number of concerns with certain provisions of the Draft Legislation and statements in the Explanatory Notes which we believe should be addressed. We also note that some of the matters in our Previous NRT Submission have not been addressed. In our view, these matters are significant enough that they should be further considered so have been raised again in this submission (see Section B).

## A. COMMENTS ON PROPOSED AMENDMENTS

### 1. "Resident Portion"

#### a. Meaning of "In Respect Of"

Paragraph (a) of the definition of "resident portion" in subsection 94(1) provides that the property to be included is property held by the trust "in respect of which a contribution has been made… to the trust…". It is uncertain how the provision is meant to apply in some common situations.

> *Example #1:*
> A Canadian resident contributes $1 to a NRT and a non-resident contributes $9. The $10 is deposited into one bank account.

We interpret paragraph (a) to provide that only the $1 will be considered the resident portion in the NRT and the $9 will be the non-resident portion, but it is not clear. Should the "property" of the NRT be the cash in the account (which can be separately traced as described) or the bank account itself? If the latter, since a contribution by a Canadian resident was made "in respect of" the bank account, is the entire bank account the property included in the resident portion?

> *Example #2:*
> The NRT uses the $10 in its bank account to acquire 1 share of a corporation.

As there is only one property held by the NRT (the one share) and a contribution by a Canadian resident was used to purchase a fraction of the one share, we are concerned that paragraph (a) could be read to conclude that the one share is a property "in respect of" which a contribution was made by a Canadian resident; the result being that the entire one share is included in the resident portion.

We believe the provision should be interpreted so that 10% of the one share should be included in the resident portion.

We point out that our interpretation is supported by the legislation as drafted. Paragraph (c) of the resident portion definition provides that it includes property "to the extent that it is… substituted for a property described by paragraph (a)…"[emphasis added]. As the cash is the contributed property, the one common share would be substituted property and governed by paragraph (c). As paragraph (c) only includes a property in the resident portion to the extent that it is substituted for property under (a) (i.e., the $1 cash), only 10% of the common share should be included in the resident portion.

> *Example #3:*
> A NRT holds shares in a foreign corporation (Forco) worth $99, which were contributed to the NRT by a non-resident. A Canadian resident thereafter transfers property to Forco; the transfer does not qualify as an "arm's length transfer", as defined in subsection 94(1), and results in a $1 increase in the value of the Forco shares held by the NRT. As such, the transfer to Forco will be deemed a $1 contribution to the NRT by the Canadian resident.

As the only property held by the NRT is the shares of Forco, we assume it was intended that the contribution to the NRT by the Canadian resident would be considered to be made "in respect of" those shares (there is no other property of the NRT that can be connected to the contribution) – see, however, our discussion in 1(b) below regarding our concerns about how to determine the property to be included in the resident portion where a contribution to the NRT is as a result of a deemed transfer under subsection 94(2). We are concerned that paragraph (a) could be read to conclude that all of the Forco shares are included in the resident portion. We believe that the intended result is that only a portion of the Forco shares be included in the resident portion. On that basis, the amount to be included should be the proportion of the Forco shares that the increase in the fair market value of the Forco shares as a result of the deemed contribution ($1) is of the fair market value of all of the shares of Forco immediately after the deemed contribution ($100); that is, 1% of the Forco shares should be included in the resident portion.

**Recommendation**

We recommend that paragraph (a) of the resident portion definition be amended to clarify that, where there is property of the NRT in respect of which both resident and non-resident contributions have been made, only the portion of the property that relates to the resident contributions will be included in the resident portion. This may be accomplished by specifying that the resident portion includes the property "in respect of which, but only to the extent of which, a contribution has been made… to the trust by a… connected contributor or a resident contributor…".

**b. Effect of Certain Deemed Transfers Under Subsection 94(2)**

Where a contribution to a NRT is as a result of a deemed transfer of property to the NRT pursuant to the application of subsection 94(2), it is not clear what actual property held by the NRT will be included in the resident portion. Considering that the definition of resident portion

refers to the "*property held by the trust"* it would appear that an additional rule is necessary to link such actual property to the property that was deemed to be transferred to the trust.

In a situation where a contribution made by a Canadian resident is as a result of a deemed transfer pursuant to subsection 94(2), and there is an actual contribution made by a non-resident, is it intended that the contribution resulting from the deemed transfer will replace the actual contributed property? If the answer is yes, it is not clear that this interpretation can be made from the Draft Legislation.

Our concerns are illustrated in the following examples.

> *Example #1:*
> A NRT provides services to a non-resident person and charges $110,000. The NRT hires a Canadian resident to perform the services on its behalf for $40,000 in fees. The fair market value of the Canadian resident services is $100,000. The services performed by the Canadian resident are not "exempt services" and do not qualify as an "arm's length transfer". As such, the Canadian resident will be considered to have made a contribution to the NRT equal to either $100,000 (the fair market value of the services provided "to" the trust) or $110,000 (the fair market value of the services provided "on behalf of" the trust).

In this example, it is not clear what property of the NRT would be included in the resident portion with respect to the service provided to or on behalf of the trust. That is, it is not clear whether all or a portion of the service fee received by the NRT is the property "in respect of which" the contribution of the subparagraph 94(2)(f)(i) deemed property was made. Paragraph 94(2)(h) and subparagraph 94(2)(f)(i) together deem the fair market value of the service provided by the Canadian resident to be a property transferred to the trust, even where some amount has been paid to the Canadian resident for the service. If the NRT paid the Canadian resident with a portion of the fees received, it would seem to be appropriate for the net increase in the property of the NRT of $70,000 ($110,000 less $40,000) to be included in the resident portion. Alternatively, if the NRT used other funds that make up part of the non-resident portion to pay the Canadian resident before it received the fees, it would appear that the full value of the services ($100,000 or $110,000) might be included in the resident portion. If the NRT never receives the $110,000 fee (e.g. it becomes a bad debt), would any of the property of the NRT still be included in the resident portion? Is the NRT required to apply a "tracing" approach to track the source of funds used to pay expenses or distributions in determining whether the resident portion or non-resident portion of property has been reduced as a result?

> *Example #2:*
> A non-resident makes a contribution of marketable securities to a NRT worth $100. A Canadian resident provides investment management and advice to the NRT for no fee; the fair market value of the service is $20. The service is neither an "exempt service" nor an "arm's length transfer", both as defined in subsection 94(1). As such, the Canadian resident will be considered to have made a contribution worth $20 to the NRT.

We assume it is intended that, of the $100 worth of marketable securities, $20 will be included in the resident portion. Unless there is a way to directly trace the service to a particular security or securities, we assume it is intended that the $20 contribution will be apportioned among all of the

securities based on fair market value (i.e., a portion of all of the marketable securities will be a resident portion).

> *Example #3:*
> A non-resident trust holding only foreign property has neither a resident contributor, nor a resident beneficiary, at a point in time. Thereafter, the non-resident trust obtains a loan of $50 that is used, together with other property of the non-resident trust to acquire an additional foreign property for $100. A Canadian resident provides a guarantee for the loan in a transaction that does not qualify as an "arm's length transfer" as defined in subsection 94(1). At that time, the Canadian resident will be deemed to have made a transfer of property to the trust equal to the amount of the loan and will, as a result, be a resident contributor to the non-resident trust. The trust will become a NRT.

While the guarantee is a contribution of property to the NRT, it is not clear to which property the contribution attaches; i.e., which property of the NRT becomes part of the resident portion. We assume it is intended that a portion of the property acquired by the NRT with the loan proceeds will be included in the resident portion.

In this case it is important that the property of the trust be identified because the NRT has also incurred a loan to acquire property that might not otherwise be entirely included in the resident portion without reference to paragraph (b) of the resident portion definition. To ensure that there is not a double counting of the effect of the loan and guarantee on the resident portion addition it is necessary to know which property of the trust the deemed property contribution is related to. In the above example, the deemed contribution of $50 might potentially be included in the resident portion under paragraph (a) of the definition but a further amount may also be included under paragraph (b) of the definition because of the $50 loan.

**Recommendation**

We recommend that the Draft Legislation be amended to make clear how deemed transfers of property to a NRT will affect the resident portion of the NRT; i.e., to make clear which property of the NRT will be treated as part of the resident portion. In addition to the legislative changes, we recommend that examples be included in the Explanatory Notes to help illustrate how the resident portion is to be determined where there is a deemed transfer of property to the NRT as a result of subsection 94(2).

### c. NRT Income to be Added to the Resident Portion - Sourcing

Paragraph (d) of the resident portion definition provides that the resident portion will include property "to the extent that it is derived, directly or indirectly, in any manner whatever, from property described by any of paragraphs (a) to (c)…". The use of the word "derived" connotes a concept of tracing and linking similar to concepts used in paragraph 20(1)(c) and is consistent with the general notion of sourcing income as set out in section 4. We note that Black's Law Dictionary defines "derived" as "received from a specified source".

Paragraph (c) of the resident portion definition provides that property will be included in the resident portion to the extent that it is substituted for property that is included in the resident portion. Such a substituted property rule contemplates a tracing or sourcing of original assets.

The analysis of the example of the computation of the resident portion on pages 34 – 37 of the Explanatory Notes does not apply sourcing or tracing principles, but instead simply adds to a resident portion that proportion of the NRT income that the resident portion is of all property of the trust. This apportioning is also applied to capital gains. It is not clear whether this is calculated based on current values or historical values.

In particular, in the example on page 34 of the Explanatory Notes, if Mary contributes $200,000 to the trust which is deposited in an interest-bearing foreign account, we submit that this account is included in paragraph (a) of the definition of the resident portion because it is "property held by the trust ... in respect of which a contribution has been made ... by a contributor that is ... a resident contributor." It follows that all of the interest income from this account should be included in the resident portion because it is "derived" from property described in paragraph (a).

By the same token, neither the guaranteed investment certificate nor the shares of Corporation A should be included in the resident portion because, on the facts of the example, no contribution was made in respect of either property by either a connected contributor or a resident contributor. We submit that it follows that no part of the income from the guaranteed investment certificate and no part of the gain on the disposition of the shares of Corporation A should be included in the resident portion. The analysis of the above example in the Explanatory Notes does not do this – it applies a proportional allocation based on the value of the resident portion and the non-resident portion.

We note that the example under subsection 94(16) in the Explanatory Notes does use a tracing concept that conflicts with the examples under resident portion. In particular, the example provides that $2,000 of net income was earned by a NRT the property of which consists of $50,000 of resident portion and $10,000 of non-resident portion. In speaking of the income of the NRT, the Explanatory Notes provides, "All of the income and losses result from the property contributed by the current and former residents of Canada. The $10,000 of property contributed by persons who have never been resident in Canada did not result in any income or losses during the 2011 taxation year." The numerical calculations thereafter apportion none of the income of the NRT to the non-resident portion. We submit that this is the correct way to apply paragraph (d) of resident portion.

**Recommendation**

We recommend that the examples in the Explanatory Notes be amended to follow the provisions in paragraphs (c) and (d) of the resident portion definition such that a sourcing or tracing concept is applied.

**d. NRT Income to be Added to the Resident Portion – Certain Income on the Non-Resident Portion**

Paragraph (d) of the resident portion definition provides that "without limiting the generality of the foregoing [being the general inclusion of property derived from a resident portion], [the resident portion is determined] including property derived from the income… of the trust for a taxation year of the trust…".

Pursuant to paragraph 94(3)(f), income of the NRT includes income derived from a non-resident portion to the extent it comes within paragraphs 115(1)(a) to (c) (the "115 income"). If the NRT earned additional income upon investing the 115 income, it would appear to be property derived from the income of the NRT and be caught under paragraph (d) of the resident portion definition. We assume this is not intended.

**Recommendation**

We recommend that paragraph (d) of the resident portion definition be amended to clarify that the income of the NRT for a taxation year, referred to therein, does not include any income derived from a non-resident portion.

**e. Indebtedness and paragraph (b)**

Paragraph (b) of the definition of resident portion is intended to operate to include all or a portion of a property (the property or portion thereof being referred to as the "subject property") in the resident portion, where a NRT has incurred indebtedness in the course of acquiring the property, the subject property would not be included in the resident portion without reference to paragraph (b), and the acquisition of the subject property by the NRT is not a contribution to the trust.

It is not entirely clear why a "substituted property" concept is needed in this paragraph given that paragraph (c) of the resident portion definition already deals with substituted property. "Substituted property" does not appear to be a defined term, so its intended meaning in this context is not clear. Furthermore, although it appears that the intention is that only one of the "initial property" or the "substituted property" would be treated as a subject property in connection with one indebtedness, the wording is not clear in this respect, and picking up both (or additional "substituted property") could lead to double (or "multiple") counting.

> *Example #1:*
> A NRT borrows $100 for the purpose of incorporating a company and deposits the funds in its bank account. The following day, it uses the funds to subscribe for shares of Forco (a non-resident corporation). Assume that neither the $100 deposit (the "property") nor the shares of Forco (the "substituted property") is otherwise included in the resident portion. Assume the trust has other properties included in the resident portion.

It would appear that all or a portion of the $100 bank deposit could be included in the resident portion under paragraph (b) (depending on the results of the application of the formulae in (i) or (ii) as the case may be), because the NRT incurred indebtedness in the course of acquiring the bank deposit, the property would not otherwise be included in the resident portion and the acquisition of the property is not a contribution to the NRT. In contrast, it would appear that the Forco shares (assuming these constitute "substituted property") would not be included in the resident portion under paragraph (b), since the acquisition of the Forco shares would be a (deemed) contribution to the trust, by virtue of paragraph 94(2)(g), and would therefore not be excluded from the application of the formulae. It is not clear whether the existence of the "substituted property" would rule out the application of paragraph (b) with respect to the application of the "initial property" acquired in the course of incurring the indebtedness". Furthermore, if the borrowed funds were instead used to acquire a marketable security, such that

the acquisition of the security is not a contribution to the NRT, it is not clear whether there could be a double inclusion in the resident portion: once for the funds borrowed and second with respect to the marketable securities acquired with the borrowed funds.

**Recommendation**

The reference to "substituted property" should be removed from paragraph (b), as it does not appear to be necessary. Alternatively, if it is intended that only one of the "initial property" or a "substituted property" be treated as the subject property in respect of any one indebtedness incurred this should be clarified. What is meant by the term "substituted property" should also be clarified.

**f. Indebtedness and Subparagraph (b)(ii) where multiple subject properties are acquired during a year**

It is not clear how the formula in subparagraph (b)(ii) of the definition of resident portion would be applied in the event that multiple subject properties are acquired in the same taxation year. The provision indicates that the formula in subparagraph (i) is to be computed using property values as at the end of the year and on the assumption that the subject property was not held at the end of the taxation year. Because the provision appears to apply separately in respect of each subject property it is not clear how to characterize the other subject properties (i.e. as being included in the resident portion or not) for the purpose of determining the formula amount. Similarly, it is not clear how to characterize property derived from the subject property (e.g. income earned on the subject property), prior to determining what portion of the subject property itself is to be included in the resident portion. Finally, it is not clear whether property substituted for the subject property would be excluded in computing the formula amount.

**Recommendation**

The amount determined under subparagraph (b)(ii) should be determined under the assumption that no subject property, nor property substituted therefor or derived therefrom, was held by the trust at the end of the taxation year.

## 2. Section 216 Election

Subsection 216(1) of the Act permits a non-resident to elect to file a return under Part I in respect of certain types of Canadian source income (most commonly, rental income on Canadian property). Where property of a NRT is included in the NRT's non-resident portion, we believe the NRT should be entitled to make an election under subsection 216(1).

Subparagraph 94(3)(a)(viii), however, provides that a NRT is deemed to be a resident of Canada in determining its liability under Part XIII on amounts paid or credited to it. As such, a NRT is not a non-resident for the purposes of applying Part XIII of the Act; subsection 216(1) only applies to non-resident persons. Accordingly, it appears that a NRT cannot file a return under section 216(1).

The proposed addition of subsection 216(4.1) does not appear to address this situation as it only appears to address the withholding requirements of an agent, and does not specifically permit a Part I tax return filing by the trust in respect of income on property of the NRT that is included in the NRT's non-resident portion.

**Recommendation**

We recommend that subparagraph 94(3)(a)(viii) be revised to clarify that subsection 216(1) can apply to applicable types of property included in the non-resident portion of a NRT.

### 3. Withholding Tax on Expenses Paid from the Non-Resident Portion

Subparagraph 94(3)(a)(ix) provides that amounts paid by a NRT are to be subject to Part XIII withholding tax if paid to a non-resident. This provision makes sense in respect of costs incurred that are deductible in computing an NRT's income for Canadian tax purposes; pursuant to subparagraph 94(3)(f)(ii), only those expenses incurred for the purposes of earning income from the resident portion are deductible. We submit that expenses should not be subject to Part XIII withholding tax if they are not incurred for the purpose of earning income from the resident portion.

**Recommendation**

We recommend that subparagraph 94(3)(a)(ix) be modified to provide there is no Part XIII withholding tax on an outlay or expense paid by a NRT to a non-resident person to the extent the amount is not deductible by virtue of subparagraph 94(3)(f)(ii).

### 4. Filings under Section 233.3

A Canadian who contributes property to a NRT is required file an information return under section 233.2. Where that contributor is also a beneficiary of the NRT, the person is also required to file a return under section 233.3 (if the total cost of foreign assets held by that person is more than $100,000). It would appear that the reporting under section 233.3 is somewhat redundant as the reporting under section 233.2 already reports the amounts contributed to the trust.

**Recommendation**

We recommend that the reporting requirement under section 233.3 not include a contribution to a NRT by a Canadian where that Canadian already reports the contribution under section 233.2.

## 5. Non-Resident Time

The definition of "non-resident time" has been amended to address the issue raised in the Previous NRT Submission. There is still a concern, however, that the application of this definition could result in anomalous results, as detailed in the following example.

> *Example:*
> An individual (A) contributes property to a NRT in 2012. A has been a non-resident of Canada since 2006, but was previously a resident of Canada for at least 5 years prior to 2006. A is not beneficially interested in the NRT. A immigrates to Canada in 2018 and dies in 2020 while still a resident of Canada. In 2021, a portion of the trust property is resettled onto a new trust that is not resident in Canada, but under which there is at least one Canadian resident beneficiary.
>
> Upon A becoming resident in Canada in 2018, the trust is deemed to be a resident of Canada under subsection 94(3). When A dies in 2020, the trust will no longer be deemed a resident of Canada as there is no resident contributor or connected contributor.

Pursuant to the proposed definition of "non-resident time", however, the new trust created in 2021 will be deemed to be resident in Canada as a result of the application of paragraph 94(2)(n). This paragraph will deem A to be a contributor to the new trust and the contribution will be deemed to have been made in 2021. As A was a resident of Canada at the time of death, A's deemed contribution to the new trust in 2021 will not be at a non-resident time.

**Recommendation**

We recommend that paragraph 94(2)(n) be revised so a contribution to the particular trust (the "original contribution") should not be deemed to be a contribution to the other trust if the original contribution was made at a non-resident time.

## 6. Computation of Income of NRT

### a. Income from non-property sources

Pursuant to subparagraph 94(3)(f)(i), the income of the NRT is to be determined by excluding the income or loss from property included in the non-resident portion or taxable capital gains or allowable capital losses from dispositions of such property (except for amounts included under paragraphs 115(1)(a) to (c)). It would appear that income from a foreign business carried on using the non-resident portion of property would not be excluded from the NRT's income. Presumably this is not the intended result.

**Recommendation**

We recommend that the exclusion in subparagraph 94(3)(f)(i) for income or gains from property that is part of the non-resident portion be amended to refer to income from any source that is derived from the non-resident portion.

**b. Deduction of Expenses**

While amounts included in a NRT's income for a taxation year under subparagraph 94(3)(f)(i) include amounts earned on a non-resident portion if includable under any of paragraphs 115(1)(a) to (c), expenses are only deductible under subparagraph 94(3)(f)(ii) if they are incurred in respect of the resident portion. We assume it was intended to also permit a deduction of expenses to the extent they were incurred to earn income on the non-resident portion that is included because of paragraphs 115(1)(a) to (c).

Subparagraph 94(3)(f)(ii), in turn, does not permit a deduction for expenses unless they were incurred for the purposes of gaining or producing income from a property that is part of the resident portion. The reference to income from property could be interpreted as not applying to income from other sources, such as a business.

**Recommendation**

We recommend that subparagraph 94(3)(f)(ii) be amended to permit the deduction of expenses to the extent they were incurred to earn income that is included in the NRT's Canadian income under subparagraph 94(3)(f)(i).

## 7. Exempt Foreign Trusts

We welcome the changes to proposed paragraph (h) of the definition of "exempt foreign trust". These changes go a long way in addressing our concerns set out in the Previous NRT Submission.

**a. Specified Fixed Interest**

We also welcome the comments in the Explanatory Notes with respect to the meaning of "specified fixed interest". Together with the changes to the definition, these comments alleviate the concerns raised in our Previous NRT Submission with respect to statements by Canada Revenue Agency officials as to the meaning of "discretionary power".

One matter of potential concern with respect to the meaning of "discretionary power" arises in the context of a trust that is created with multiple classes of units or sub-funds. In that case, the trust may have items of income, expense or other payments that are not identifiable with any specific class or sub-fund. In order to deal with this, the declaration of trust may give the trustee the discretion to allocate such amounts among the various classes of units or sub funds. It is implicit that such discretion will be exercised in a fair and equitable manner. It could be argued that the effect of such a provision is that the amount of the income or capital to be distributed in respect of a particular unit of the class or sub-fund depends on how such discretion is exercised. We assume that this kind of discretion is not intended to be caught by the meaning of "discretionary power", but we request confirmation of this.

**Recommendation**

We recommend that the Explanatory Notes be revised to clarify that administrative discretion to allocate items of income, expense or payments among classes of units or separate units within a family of sub-funds is not intended to disqualify an interest as a specified fixed interest.

**b. Commercial Trusts**

In order to qualify as an "exempt foreign trust", all of the beneficiaries of a non-resident trust must hold only specified fixed interests and one of the conditions in subparagraph (h)(ii) of the definition of "exempt foreign trust" must be met. One of these conditions is set out in clause (h)(ii)(C) of the definition, which requires that each outstanding specified fixed interest in the trust[1]:

> (I) was issued by the trust in exchange for consideration that was not less than 90% of the interest's proportionate share of the net asset value of the trust's property at the time of its issuance, or
>
> (II) was acquired in exchange for consideration equal to the fair market value of the interest at the time of its acquisition.

We interpret subclause (II) as referring to the acquisition of an interest in a non-resident trust either by a person making a contribution to the trust or by a third party who subsequently acquires that interest for consideration equal to the fair market value of the interest at the time of the subsequent acquisition. In the Explanatory Notes for this provision, however, it is indicated that the provision applies to interests "acquired for fair market value <u>at the time the interest was issued</u>" [emphasis added]. We expect that the underlined words should have referred to the fair market value at the time the interest was acquired (i.e., in the case of a subsequent acquisition by a third party). We request confirmation of this.

**Recommendation**

We recommend that the Explanatory Notes to subclause (h)(ii)(C)(II) of the definition of "exempt foreign trust" be amended to confirm that the subclause contemplates a subsequent purchase of an interest in a trust at fair market value at the time it is acquired by the third party.

**c. Indirect Contributions through a Commercial Trust**

Paragraph 94(2)(n) provides that a contribution by a trust to another trust is deemed to have been made jointly by the first trust and by each person that is a contributor to the first trust. Paragraph (b) of the definition of "contribution" also provides that, if a transfer of property is made by a person as part of a series of transactions that includes a second transfer by another person to a trust, the second transfer is deemed to be a contribution to the trust by the first person, if the two transfers are not arm's length transfers and the second transfer can reasonably be considered to have been made in respect of the first transfer. As a result of these provisions, a contributor to an

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[1] We note that the words "in the trust" are duplicated in clause (h)(ii)(C). We assume that this is a typographical error.

exempt foreign trust could be considered to also be a contributor to an underlying trust. These provisions cause concerns, for example, where a foreign investment fund is structured with one or more tiers of subsidiary trusts.

> *For example:*
> A publicly-listed Australian trust ("Top Trust") qualifies under paragraph (h) of the definition of exempt foreign trust. Top Trust holds all of the units of a family of Australian subsidiary trusts ("Sub Trusts"). Depending on what class of units in the Top Trust is subscribed for by an investor in Top Trust, funds received by the Top Trust from the issuance of its units are contributed to one or more Sub Trusts. Such contributions may not be at fair market value – i.e., they may not qualify under paragraph (h)(ii) of the definition of exempt foreign trust.

If paragraph 94(2)(n) or paragraph (b) of the definition of "contribution" applies, the Sub Trusts would not be exempt foreign trusts and, if there are Canadian contributors to the Top Trust, subsection 94(3) would apply to the Sub Trust and the Canadian contributors. We submit that, if the Top Trust qualifies as an exempt foreign trust, these provisions should not apply. The underlying structure of an exempt foreign trust should not be relevant.

**Recommendation**

We recommend that paragraph 94(2)(n) and paragraph (b) of the definition of "contribution" be revised to exclude transfers to exempt foreign trusts.

## 8. Penalties for Late Filing

The NRT rules are to be effective for taxation years that end after 2006. There is also the ability for a trust to elect for these rules to apply to taxation years that end after 2000 if the trust was created in one of those years. As a result, some trusts that were not required to file under former section 94 may now be required to file a return of income for taxation years that are past due. There is no legislative provision that would allow such a trust to file late without penalty.

In addition, some trusts that were either required to file under former section 94, or that chose to file under the proposed NRT rules even though they were not yet law, may want or need to file an amended return to take into account changes to the proposed legislation.

**Recommendation**

It is recommended that a transitional provision be included that would allow NRT's to file late without being assessed a late filing penalty. In addition, it is recommended that NRT's be permitted to file amended returns (even if beyond the normal reassessment period) that will be processed by the Canada Revenue Agency ("CRA") and without being assessed a penalty (if a penalty would otherwise apply).

The Explanatory Notes suggest that the CRA be contacted for more details on the filing obligations regarding returns of income. If a legislative amendment is not to be included in these

rules, we recommend that the CRA publicly announce what its administrative practice will be with respect to the late filing of returns of income, and amended returns of income, for NRTs.

## B. OTHER CONCERNS

While the Draft Legislation addresses many of the concerns we raised the Previous NRT Submission, we submit that some of the comments not addressed should be reconsidered.

### 1. Trusts for Administering or Providing Employee Benefits

Paragraph (f) of the definition of "exempt foreign trust" refers to a trust that has been operated exclusively for the purpose of administering or providing employee benefits which meets three conditions set out in subparagraph (ii) of the definition.

#### a. Foreign Stock Option Plans

The condition in clause (f)(ii)(A) of the definition of "exempt foreign trust" provides:

> (A) the trust is governed by an "employee benefit plan" or is a trust described in paragraph (a.1) of the definition of "trust" in subsection 108(1).

In the July 16, 2010 proposed technical amendments to the Act, it is proposed that paragraph (a.1) of the definition of "trust" in subsection 108(1) will be amended to exclude a trust to which subsection 7(2) or (6) of the Act applies. This change creates concerns for non-resident trusts that are created in connection with foreign employee stock option plans.

> *For example:*
> A non-resident corporation ("Parentco") is a public corporation with a Canadian subsidiary ("Canco"). Parentco has a stock option plan for its employees. Under the plan, Parentco issues (contributes) shares of its capital stock to a non-resident trust for the benefit of employees under the plan. Canco pays amounts to Parentco in respect of that contribution, either because the Parentco contribution is in respect of employees of Canco, or because the contribution is in respect of other employees who perform services that benefit Canco.

Canco is deemed to make a "contribution" to the non-resident trust if the payment to Parentco is part of the same series of transactions that includes the transfer of Parentco shares to the trust. The payment to Parentco and the transfer of Parentco shares to the trust are not "arm's length transfers" if one of the reasons for the payment or transfer is an acquisition of interests in the trust by persons under the stock option plan. Accordingly, the requirement in clause (A) above may not be met.

**Recommendation**

We recommend that clause (f)(ii)(A) of the definition of "exempt foreign trust" be expanded to apply to trusts to which subsection 7(2) or (6) of the Act applies.

### b. Foreign Employee Benefit Plans

The condition in clause (f)(ii)(C) of the definition of "exempt foreign trust" provides:

> (C) no benefits are provided under the trust, other than benefits in respect of qualifying services

Subject to a limited exclusion, a "qualifying service" does not include services that are rendered primarily in Canada. Accordingly, subject to that limited exclusion, the requirement in clause (C) would not be met where any of the benefits under a non-resident trust are provided to Canadian employees. This could inhibit the ability of multinational corporations to provide the same benefits to Canadian employees as are provided to employees in other countries, even where the Canadian employees form only a small part of the overall employee benefit plan.

**Recommendation**

We recommend that clause (f)(ii)(C) of the definition of "exempt foreign trust" be expanded to permit Canadian employees of foreign multinationals to participate in employee benefit plans (including trusteed stock option plans) where they make up a very small proportion of the total plan membership.

## 2. Income Tax Conventions Interpretation Act

It is proposed that the ITCIA be amended to provide that, if a trust is deemed by proposed 94(3) to be resident in Canada, the trust is deemed to be a resident of Canada and not a resident of a contracting state, for the purposes of applying an income tax convention. According to the Explanatory Notes:

> This amendment is intended to ensure consistent application of Canada's treaties and in a way that conforms to a principal objective of Canada's tax treaties, namely of preventing tax avoidance and tax evasion.

As we noted in the Previous NRT Submission, Canadians can contribute to foreign trusts for legitimate family reasons not related to Canadian income tax. Where it can be demonstrated that there is no tax avoidance or tax evasion, or potential for tax avoidance/evasion, a foreign trust should not be subject to proposed subsection 94(3). Where the trust would otherwise be resident in a treaty jurisdiction, it should be possible to resolve the matter of residence using the "tie breaker rules" under the treaty or through the competent authority procedures under the treaty.

We recognize that the proposed foreign tax credit provisions are intended to avoid double taxation of the trust, but this does not address all of the concerns. For example, where a non-resident trust has been created for legitimate family reasons, it would be unfair to impose Canadian withholding tax on distributions of non-Canadian source income from the trust to a non-resident beneficiary.

**Recommendation**

The proposed amendment to the ITCIA should not override a trust's residency determination under tie breaker rules in a treaty or the possibility of a determination of residence under the competent authority procedures in a treaty.

## 3. Section 94.2

If a resident beneficiary, either alone or together with persons not dealing at arm's length with the resident beneficiary, holds 10% or more of the specified fixed interests in a non-resident commercial trust, the trust is deemed to be a controlled foreign affiliate of the resident beneficiary for the purposes of certain provisions of the Act, but not for the purposes of the foreign affiliate provisions in the Act dealing with the taxation of distributions of exempt surplus.

The application of Canada's foreign affiliate rules to non-corporate entities was considered by the Minister of Finance's Advisory Panel on Canada's System of International Taxation. In this connection, paragraphs 4.72 and 4.73 of the Advisory Panel's Report state:

> **Application to other foreign entities**
>
> 4.72 Under the current rules, only a foreign corporation can qualify as a foreign affiliate. This treatment presumes that active business is carried on only through entities that are corporations. In many countries, business can be conducted through entities or forms of association that are not corporations but are taxed as if they were. In some countries, using a corporation may not be the optimal or most tax-efficient form of association through which to conduct certain businesses locally. However, using the better form of association may have adverse Canadian tax consequences.
>
> 4.73 The Panel suggests the government consider amending the definition of "foreign affiliate" of a taxpayer resident in Canada to include any non-resident entity where the taxpayer and related persons hold equity interests in the entity that would be the equivalent of an interest in a foreign affiliate if the entity were a corporation and its equity interests were shares.

Paragraph 4.104 of the Advisory Panel's Report concludes that the government should undertake a fresh review to coordinate the FAPI, FIE and NRT regimes, to ensure that all passive income is taxed on an accrual basis and to focus on the scope of these rules so that they do not impede *bona fide* commercial business transactions.

We agree with the Advisory Panel's comments and we think that they should apply to entities covered by section 94.1 and proposed section 94.2 as well. In our view, commercial trusts that are covered by proposed section 94.2 should be subject to the entire foreign affiliate system and not just certain rules within the system.

**Recommendation**

Consistent with the Advisory Panel's Report, trusts subject to new section 94.2 should be deemed to be foreign affiliates and be subject to all of the foreign affiliate rules and not just certain rules within that system.

This recommendation applies not just to trusts that have a direct Canadian beneficiary, but to all non-resident commercial trusts that comply with paragraph (h) of the definition of "exempt foreign trust" – i.e., to interests in commercial trusts that are held by a controlled foreign affiliate of a Canadian corporation.

## II. AMENDMENTS IN RESPECT OF FOREIGN AFFILIATES

### A. FILL THE HOLE RULES – CHANGES MADE TO FORMULAS IN REGULATION 5905(7.2)

Prior to the Draft Legislation, the formulas in Regulation 5905(7.2) caused an inappropriate loss of exempt surplus ("ES") in situations where the Canadian corporation's surplus entitlement percentage ("SEP") in the deficit affiliate was less than 100%. Our Previous Foreign Affiliate Submission highlighted this issue and recommended certain changes to the formulas to ensure consistency among the adjustments to the surplus balances of the deficit affiliate and the acquired affiliate, and the adjusted cost base adjustment under Regulation 5905(7.6).

The Draft Legislation now includes changes to the formulas, as suggested in our Previous Foreign Affiliate Submission. However, in certain situations, the formulas still do not operate effectively. This is mostly due to the fact that the concept of deeming the deficit affiliate to be resident in Canada is not consistent throughout the computations.

For example, under proposed 5905(7.2), on a liquidation of FA2 in the situation illustrated in Schedule 1, FA3's exempt deficit is increased to $400 computed as the lesser of:

- $300 (FA2's exempt deficit)/60% (FA2's "SEP" in FA3) = $500; and
- $400 (FA3's tax-free surplus balance)

FA2's exempt deficit is, however, only reduced to $60 ($400 (fill-the-hole amount) x 60% (FA2's "SEP" in FA3) equals $240 reduction in exempt deficit), which residual deficit disappears on the liquidation. Canco's consolidated surplus entitlement becomes nil, which is a reduction of $100 relative to the starting point. This result is obviously not appropriate since the purpose of the fill-the-hole rules is to reallocate existing surplus balances, but should not result in an overall reduction of 'consolidated' surplus entitlement.

The Draft Legislation inappropriately reduce surplus in circumstances where Canco's SEP in the acquired affiliate exceeds the deficit affiliate's SEP in the acquired affiliate, i.e., where Canco owns its shares in the acquired affiliate through more than one "chain" of ownership. The smaller the deficit affiliate's SEP in the acquired affiliate relative to Canco's overall SEP in the acquired affiliate, the more extreme the result becomes.

**Recommendation**

To solve this issue, it is necessary to step back and consider various scenarios to ensure that in making changes to these provisions an inappropriate loss of surplus does not arise. This theoretically should be possible by consistently ensuring that surplus is retained for Canco's share of surplus not "blocked" by the deficit and only reducing surplus of an acquired affiliate to the extent it is appropriately allocated to the deficit affiliate, assuming for this purpose that it is resident in Canada such that higher tier variations in SEP do not impact the adjustment.

### B. AMENDMENTS TO BUMP DESIGNATIONS

For post-December 18, 2009 acquisitions of control, Regulation 5905(5.4) reduces the "bump room" by the tax-free surplus balance ("TFSB") in the foreign affiliate at the time of the acquisition of control. Consequently, up-to-date surplus calculations are required essentially every time a bump designation is made. However, in many cases, the target may not have up-to-date surplus calculations. Reliable information may be difficult or impossible to obtain if it relates to periods before the acquisition of control (e.g., where the seller is uncooperative or where the target has undergone several changes in ownership). Additionally, in many jurisdictions, the audit cycle is at least as long as the cycle in Canada and tax return filings are often not made until many months (or even years) after the end of the taxation year.

The Draft Legislation introduces the ability to amend an initial bump designation for up to a 10 year period. However, the amendment will only apply if, in the opinion of the Minister, it is "just and equitable" to permit the initial designation to be amended. The Explanatory Notes indicate that the "just and equitable" standard would be met where the taxpayer's computation of the TFSB required adjustment because of a foreign tax assessment or an adjustment made on audit by the Minister.

In many cases, and in spite of reasonable efforts being made, it is very difficult, if not impossible, to obtain information from acquired foreign entities to accurately compute their surplus balances.

**Recommendation**

We submit that there will be many instances where bump designations will need to be amended due to the fact that information required to compute surplus is simply unavailable. These instances will have nothing to do with foreign or Canadian tax assessments. We recommend that these types of circumstances should also be covered by the "just and equitable" standard provided in the Draft Legislation.

## C. SIMPLIFICATION OF BUMP DESIGNATION RULES

In circumstances where shares of a foreign affiliate are distributed shortly after the acquisition of control (say, for example, 90 days) and the surplus of the foreign affiliate was not actually utilized by the taxpayer following the acquisition of control, it is expected that the taxpayer would fully bump the tax cost of the foreign affiliate shares (without regard to surplus balances) and would distribute the foreign affiliate shares from Canada without the need for a subsection 93(1) election (and without having actually received any dividends).

**Recommendation**

We recommend a simplifying amendment that would allow a taxpayer, at its option (by election), to avoid the need to reduce the bump designation in respect of a foreign affiliate by the TFSB in such circumstance. Such a provision would reduce complexity both for the taxpayer (by eliminating the need to calculate the tax-free surplus balance initially, and to file amended elections and designations if a change is made to such tax-free surplus balance) and for the CRA

(by eliminating the need to audit surplus balances in a situation where they are not relevant to the tax consequences of the transaction).

## D. DEFICITS IN FOREIGN AFFILIATES ON ACQUISITION OF CONTROL

While exempt surplus can be reduced on an acquisition of control and bump room is reduced by tax-free surplus, deficits in foreign affiliates are not addressed. For example, if a Canadian target owning a foreign affiliate with an exempt deficit of $100 is acquired by another Canadian corporation for, say, $1, the exempt deficit remains and must be "filled" with post-acquisition surplus before repatriating the funds to Canada.

**Recommendation**

In circumstances where an acquisition of control has occurred, consideration should be given to reducing "consolidated" or higher-tier deficits.

## E. REGULATION 5905(1)

The proposed change to Regulation 5905(1) corrects an anomaly in the calculation of surplus accounts that previously resulted in certain transactions. For example, before this proposed change, the surplus accounts of a foreign affiliate would generally not have increased on a transfer to another foreign affiliate under subsection 85.1(3), where the taxpayer's SEP in the transferred affiliate decreases (i.e., where the acquiring affiliate has other shareholders). As a result, the transfer inappropriately reduced the amount of exempt surplus that could be distributed to the taxpayer. While this proposed change is effective for transfers that occur after December 18, 2009, it does not address transfers made in earlier periods.

**Recommendation**

The coming-into-force provision in respect of Regulation 5905(1) should be revised to allow taxpayers to elect to have the provision apply retroactively in respect of all of their foreign affiliates.

# III. <u>OTHER AMENDMENTS IN RESPECT OF INCOME TAX</u>

## A. EMPLOYEE STOCK OPTIONS – APPLICATION DATES AND GRANDFATHERING PROVISIONS

In our Previous Budget Submission we raised specific concerns arising from the lack of grandfathering. These concerns remain, in addition to the following point.

**1. Withholding and remittance - Existing Option Agreements**

Employers will be required to withhold and remit tax in respect of an employment benefit under subsection 7(1) to the same extent as if a cash bonus of an equal amount had been paid out to the employee. Further, the Minister of National Revenue's statutory authority to reduce the amount to be withheld and remitted in respect of an employment benefit where the benefit arose from the acquisition of securities, will be removed.

Resolution 28 of the March 4, 2010 Notice of Ways and Means Motion provides that these two proposed changes will not apply in respect of rights under an agreement to sell or issue securities granted before 2011 if the agreement was entered into in writing before 4:00 pm EST on March 4, 2010 and included, at that time, a written condition that restricts the employee from disposing of the securities acquired under the agreement for a period of time after exercise.

We note that these two changes in the Draft Legislation have different transitional rules. Subclause 92(5) of the Draft Legislation states:

> "Subsection (2) [the specific requirement to withhold] applies after 2010, except that it does not apply with respect to benefits arising from rights granted before 2011 to a taxpayer under an agreement to sell or issue securities that was entered into in writing before 4:00 p.m. Eastern Standard Time, March 4, 2010 and that included, at that time, a written condition prohibiting the taxpayer from disposing of the securities acquired under the agreement for a period of time after exercise."

Subclause 92(6) states:

> Subsection (3) [the elimination of the Minister's statutory authority to reduce withholdings] applies after 2010.

**Recommendation**

Subclause 92(6) should be eliminated and subclause 92(5) should apply to subclauses (2) and (3) so that the draft legislation is consistent with Resolution 28 of the Notice of Ways and Means Motion.

**2. Other Concerns**

As more fully set out in our Previous Budget Submission, the application provisions for other stock-option related measures announced in the Budget also raise concerns, which have not been addressed. These are reiterated below.

**a. Conditions prohibiting a disposition**

In our Previous Budget Submission on these proposals, we pointed out that an employee may not be allowed to dispose of a particular security acquired under an agreement to sell or issue securities due to a condition that is not actually part of the security option agreement itself. For

example, an employee may be prohibited from disposing of the security due to general corporate policies or due to conditions in an employment agreement.

**Recommendation**

We recommend that the wording of the disposition prohibition in subclause 92(5) be extended to include other forms of employment conditions or policies that were in effect on March 4, 2010 that restrict an employee from disposing of shares.

**b. Stock option cash outs**

We continue to be concerned by the immediate application of the proposed amendment to paragraph 110(1)(d) and the absence of grandfathering provisions. We again emphasise that this Budget measure, included among the measures to "close tax loopholes", does not have the colour of aggressive tax positions that, in other circumstances, may have justified immediate application of amendments that preclude taxpayers from receiving the expected tax benefit. It may be that the Department of Finance disagreed with the how the rules had operated for some time, but that does not make the result a tax loophole and therefore, this is simply a tax policy change.

**Recommendation**

In keeping with the general tax principle that existing *bona fide* commercial arrangements should be protected from changes in general tax policy, we reiterate that the proposed amendment to paragraph 110(1)(d) should apply only to stock option awards made after 4pm on March 4, 2010.

## B. INFORMATION REPORTING – SECTION 237.3

In our Previous Information Reporting Submission, we set out our general concerns in regard to the May 7, 2010 Backgrounder on the proposed information reporting regime. We appreciate that the aim of these measures is to provide the tax authorities with more effective means to counter abusive avoidance transactions, and that enhanced early reporting of such transactions assists in protecting the integrity of the tax system and promoting a fairer tax system. We acknowledge that some of the concerns raised in our Previous Information Reporting Submission have been addressed, either through clarifications in the Draft Legislation or the Explanatory Notes. Nevertheless, we continue to have certain concerns on the scope of the regime.

The Explanatory Notes suggest that given the reporting regime applies if a transaction is an "avoidance transaction" and two of three hallmarks exist in respect of the transaction, "it should be the case that normal commercial transactions that do not pose an increased risk of abuse would not have to be reported under this new reporting regime." We would comment that the fact the reporting obligation is conditioned on the existence of an "avoidance transaction" is not necessarily limitative or particularly determinative of "abuse". Depending on one's determination of the relative importance of the driving forces of a transaction, numerous normal commercial transactions can be characterised as "avoidance transactions"**.** We believe that the hallmarks remain too broad to effectively focus these new reporting obligations on those transactions that pose an increased risk of abuse.

## 1. “Fee Hallmark”

The words of paragraph (a) of the definition of “reportable transaction” are susceptible of a very broad construction. We refer you to our Previous Information Reporting Submission on this point. We note the example given in the Explanatory Notes of a percentage based fee. However, there may be other *bona fide* value based billing arrangements agreed to by professional advisors that are captured by this definition.

The breadth of this hallmark largely results from the words “to any extent.” A fee that is to a minimal extent value-based creates a hallmark in respect of the transaction.

Similarly, in the context of professional services provided by multi-service firms, the tax advisory services that are related to an eventual tax benefit may be a relatively small portion of the overall fee for services rendered. It is unclear in such circumstances whether the full amount of the fee is included in paragraph (a) of the definition of “reportable transaction” (and therefore included in computing a penalty). Accordingly, these words result in uncertainty.

Alternative billing arrangements (which would generally include all arrangements that are not exclusively based on an hourly fee) are a reality in the current market, and are recognised (and to a certain extent promoted) by many professional orders. We submit that, as broad as it is, the fee hallmark will not be effective in identifying the types of transactions that present an increased risk of abuse, and will interfere with normal commercial practices among professional service firms, and bring normal commercial transactions into the ambit of the reporting rules.

### Recommendation

We suggest that fee arrangements with advisors under which the value of the advice or result obtained is one of the factors taken into consideration in setting the fee, in accordance with the rules applicable to the professional order under which the advisor practices the profession should be specifically excluded from the “fee” hallmark.

Alternatively, if the Department of Finance believes it is not possible to exclude such fees, we submit that the fee hallmark should be changed so as to capture only those fee arrangements that have a clear, direct and substantial nexus with a given tax result (i.e. the tax result is the primary criterion determining the quantum of the fee). Accordingly, we recommend that the fee hallmark be limited to fees that are primarily based on the amount of a tax benefit.

We also recommend that the fee that is relevant for paragraph (a) of the definition of “reportable transaction” and for the quantum of any penalty be limited to the advisor’s fee (or the portion of the advisor’s fee) for tax advisory services that directly relate to the tax benefit.

## 2. “Contractual Protection” and “Confidential Protection”

The “contractual protection” hallmark can potentially capture many common commercial transactions. Based on the current definition, a vendor in a share sale transaction can be considered to be providing contractual protection to the purchaser where the purchase agreement contains “market” representations of the vendor regarding the tax attributes of the target

corporation, that are supported by contractual indemnity provisions. A vendor in a share sale transaction can be considered a "promoter" who has granted "contractual protection" where the purchase agreement includes covenants for assistance in the event of disputes with third parties (which may include disputes related to tax benefits expected to accrue to the purchaser as a result of the transaction). We submit that representations that a vendor typically provides in a commercial sale transaction should not be made into a hallmark of an "abusive" transaction.

Furthermore, we note that the "confidential protection" hallmark exists where any advisor or promoter has or had confidential protection in respect of the avoidance transaction or series. A "promoter" may include a principal to a transaction; moreover, a principal in a transaction may be viewed as providing contractual protection to another party to the transaction, and therefore, may be an "advisor" in respect of a transaction.

In many normal commercial sale transactions, non-disclosure agreements are a standard step in the process by which entities are sold, because, for example, data that is not generally available is disclosed to various bidders or because the process is to remain confidential until an agreement is reached. The non-disclosure agreement may extend to contract terms and structure. Such non-disclosure agreements arguably provide "confidential protection" to the vendor or the target entity. It would appear that even in circumstances where the non-disclosure agreement is terminated (e.g. this may occur when the transaction is publicly announced or the transaction is consummated), the advisor will have had contractual protection in respect of the transaction such that a hallmark in respect of the transaction will exist.

Moreover, having regard to the retroactive application of the reporting regime in respect of series of transactions that began prior to 2011, confidentiality provisions in any pre-existing service agreement that extends, but is not limited to, the series may constitute confidentiality protection. In other words, a more general retainer between an advisor and client that is not specifically related to an "avoidance transaction" but that contains a general confidentiality provision agreed to at the beginning of the retainer could cause a transaction to be a reportable transaction. Because the confidential protection hallmark will exist where the advisor has "or had" such protection, it appears impossible for an advisor to waive or revoke that protection so as not to trigger a hallmark.

**Recommendation**

We recommend that exceptions be made to these hallmarks to exclude *bona fide* service arrangements and normal commercial transactions from the ambit of these rules. For the confidential protection hallmark in particular, the existence of this hallmark should be measured at the time an information return is required to be filed.

### 3. Subsection 237.3(12)

Due to the penalty applicable for failure to comply, and the uncertainty surrounding the application of both existing and proposed rules, taxpayers and other persons subject to a reporting obligation may decide to err on the side of caution in determining whether a transaction

is a reportable transaction. As the Supreme Court has noted,[2] the concept of "avoidance transaction" involves assessing the relative importance of the driving forces of a transaction (...) the determination invokes reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered." Accordingly the fact that an information return is filed, in itself, should not obviate the need for an objective determination of the existence of a tax benefit or an avoidance transaction.

**Recommendation**

Subsection 237.3(12) should be amended to add that the filing of an information return by a person under subsection 237.3(2) in respect of a reportable transaction is not an admission (i) that the reportable transaction is an avoidance transaction or that the transaction is part of a series that includes an avoidance transaction or (ii) that a "tax benefit" results for any particular person.

## 4. Application provisions

The reporting obligation will apply to an avoidance transaction that is part of a series of transactions that began before 2011 and is completed after 2010. We maintain our concerns with regard to the uncertainty this type of application provision will cause, having regard to the difficulty in determining which transactions may form part of a series, and the difficulty in determining whether any of the hallmarks were present at any given time. As noted previously, the breadth of these hallmarks is such that they may exist as a result of standard commercial terms which, from a tax perspective, would have been considered innocuous at the time they were negotiated. For example, some accounting firms have used non-disclosure confidentiality provisions in engagement letters for all of their tax work to ensure that third parties do not rely on the opinions they provide without specific advice as a risk management tool. In most or all cases, this provision could have easily been dropped in favour of other risk management steps such as specific disclaimers in the report provided to the client.

As a result, it would not be immediately apparent to taxpayers (and advisors) when transactions could be subject to reporting under these provisions. Taxpayers (and advisors) may, in certain circumstances, have to go back many years and review a broad range of transactions to comply with these reporting provisions; this will impose a significant burden and cost on taxpayers and all persons who may have a reporting obligation in respect of the transaction in question. While the existence of a due diligence defence may provide protection from a penalty, it also reinforces the fact that all reasonable care will have to be exercised by all persons subject to a reporting obligation to acquire the relevant information for reporting purposes. Having regard to the fact that these provisions were first announced on March 4, 2010, we do not believe it is reasonable or appropriate to place any obligations to report on transactions which pre-date this announcement.

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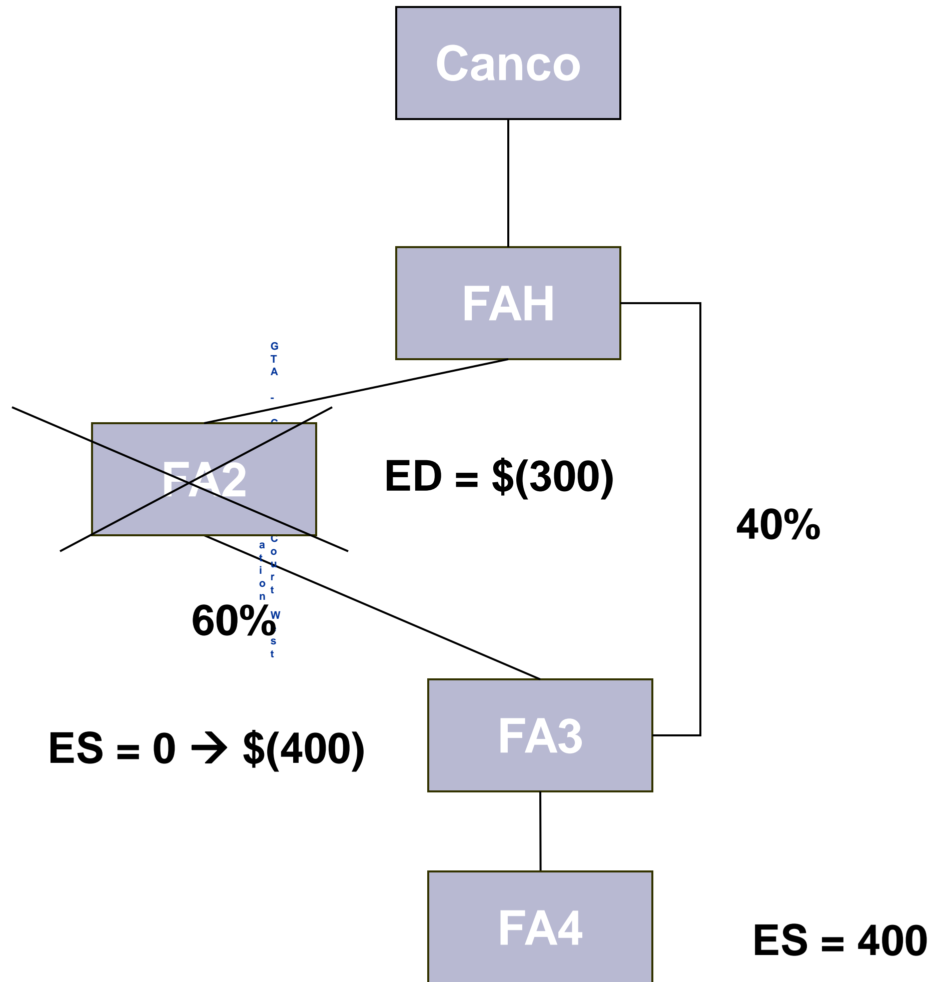
[2] *The Queen v. Canada Trustco Mortgage Co.*, [2005] 2 SCR 301.

**Recommendation**

We recommend that any series of transactions should only be made subject to the rules if the series began after March 4, 2010.

# Split Ownership Chains

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