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

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

Dear Mr. Ernewein,

Reference: Proposed Income Tax Amendments on Contingent Liabilities – Section 143.4

We are writing to you to summarize our concerns with respect to the proposed introduction of section 143.4 of the Income Tax Act (ITA). As you know, we previously provided you with a list of detailed concerns and then discussed these issues with you during our meeting in June. We subsequently had a more in-depth discussion with officials of your department in August once we learned how broadly Finance intended these rules to apply.

Based on the backgrounder that was released with the draft changes, we believed that the main purpose of the draft changes was to address the result in the *Collins* decision. In that case, a taxpayer was allowed to accrue and deduct a higher amount of interest even though the commercial arrangements made it abundantly clear that a lower amount would actually be paid.

Based on our subsequent discussions, the Government's tax policy concern with contingent amounts appears to be two-fold. First, as in *Collins*, taxpayers may gain a benefit in situations where they have the right or have made arrangements to allow them to pay a smaller amount. Secondly, your Department is concerned that some taxpayers are not actually reducing tax attributes (or recapturing those previously claimed) where accrued liabilities are discharged at a lower amount due to subsequent events. We believe that specific tax changes, much narrower in focus than those in proposed section 143.4, could be introduced to ensure that planning like that in *Collins* is no longer possible and that adjustments are required to be made once a transaction is completed.

While proposed section 143.4 is designed to deal with both issues, we believe that the proposed rules go much further than that, and introduce new general tax principles which will override the rules for contingent amounts now contained in paragraph 18(1)(e). Paragraph 18(1)(e) denies a deduction for amounts transferred or credited to a reserve, contingent account or sinking fund except as expressly permitted by Part I of the ITA. Under this rule, a taxpayer can use commercial profit as a starting point for the computation of income for tax purposes, and then adjust this amount for any expenses that represent a contingency (in addition to any other adjustment required under other provisions of the ITA). If an amount is not paid, we would have thought that most taxpayers would be required to make an adjustment at the time the liability ceases to exist to remove the liability from their accounting records. Overall, we believe that the current system, based primarily on paragraph 18(1)(e), has operated well and provides a clear framework for taxpayers to follow.

Our main concerns are related to the proposed definitions of "contingent amount" and "right to reduce" and we have focused our comments on these definitions.

<u>Definition of a "contingent amount"</u>

Under the proposed definition, a contingent amount of a taxpayer at any time (other than a time at which the taxpayer is a bankrupt), <u>includes</u> an amount to the extent that the taxpayer, or another taxpayer that does not deal at arm's length with the taxpayer, has a right to reduce the amount at that time.

We believe that the proposals should restrict the application of the contingent amount definition to situations where there is an existing right to reduce future payments, such as the arrangement at issue in the *Collins* case. In other words, the reference to the word "includes" in the definition should be changed to "means".

<u>Definition of a "right to reduce"</u>

Our second general concern is in respect of the definition of a right to reduce. In the *Collins* case, the right to reduce was a clear decision as under the terms of a binding contract, the taxpayer had two distinct courses of action to settle an interest obligation. In that case, the taxpayers had entered into an amended loan agreement that called for interest at 10% although only $20,000 was actually payable annually. The balance was payable at the end of the 16th year. The agreement also provided for an optional course of action to settle the debt along with the interest obligation, that could result in a lower payment in respect of accrued and unpaid interest. The Federal Court of Appeal held that the taxpayers could deduct the full interest accrual for the years in question despite the fact that the taxpayer could exercise this option contained in the amended agreement which could result in a discharge of the accrued interest obligation at a reduced amount.

As you know, when we first discussed this issue with your Department, it was our belief that the draft rules would apply to situations where the taxpayer in question had a right similar to that at issue in *Collins.* However, we now understand that the intention is that the "right to reduce" definition is to have broader application. Consequently, we are concerned that the definition goes well beyond the sort of situation at issue in *Collins*, and could apply to any adjustment of an expenditure amount, contractual or otherwise. For example, if certain conditions are not met, a contract may require a different payment amount, or, more broadly, a party may have general legal remedies if the counterparty fails to meet the conditions set out in an agreement, which if exercised could result in adjustments to contractual terms, including payment terms. Discussions with your officials indicated that it is Finance's view that virtually any means of changing a taxpayer's obligations should be caught (including automatic contractual adjustments and adjustments arising from legal proceedings). Accordingly, this provision would apply to all manner of legitimate commercial arrangements that contain adjustment provisions, in circumstances that do not even remotely resemble the tax-motivated planning in *Collins*.

We also have significant concerns with the "reasonable to conclude" aspect of this definition. As we understand Finance's intention, a taxpayer will be required to review all circumstances in which an adjustment may be required and then to determine whether, in the particular taxation year, it is reasonable to conclude that an adjustment will be made at a future time. We believe that such an exercise is fraught with uncertainty, will create an enormous amount of additional work, and is not necessary to redress the mischief in *Collins*. The ITA adopts the realization principle in most situations because the results are certain, both in terms of the occurrence of the event and the appropriate quantum in issue. Mark-to-market approaches are generally reserved for only the most sophisticated taxpayers. By requiring taxpayers to speculate in advance whether an event will occur and the quantum involved, these proposals will place a heavy (if not unworkable) burden on many taxpayers who simply will be unable to comply with them.

<u>Applying the proposals in practice</u>

We believe that these proposals will be exceptionally difficult to apply in practice. As a simple example, consider a routine situation where a taxpayer acquires a capital property and, under the terms of the purchase contract, conditions must be met over the next five years. The final payment is to be made at the end of five years. The taxpayer records the full liability for tax purposes, on the basis that the contractual conditions do not create a contingent liability as all parties expect that the agreement conditions will be met (this is consistent with Canada Revenue Agency policies).

After three years, there is a disagreement between the parties, and in particular, the purchaser believes that the vendor is not meeting the conditions contained in the agreement and initiates legal proceedings. Obviously, the purchaser thinks that it has a good chance of a positive outcome that will at least cover its legal expenses, but the outcome is nonetheless in at least some doubt.

The main problem in this situation is that the proposed rules are entirely unclear. In particular, will the failure to perform on the vendor's part, and the legal action initiated by the purchaser, create a right to reduce: by commencing litigation, does the purchaser have a right to reduce the amount payable under the contract that is contingent upon the occurrence of an event (the settlement of the litigation or a judgment of the court)? In addition, there are two primary measurement uncertainties: how large will the expenditure reduction be and will the action will be successful. The draft legislation and explanatory notes do not provide any guidance on what sort of level of probability is associated with a "reasonable to conclude" outcome.

<u>Conclusion</u>

Given that the Federal Government is undertaking a general red tape review, and determining whether the compliance burden can be decreased, we believe that all tax changes should be implemented only after ensuring that the following two issues are carefully considered and balanced:

1. Will the tax change result in the desired tax policy impact?

2. Will the tax change create additional compliance costs for taxpayers, and especially for those taxpayers whose affairs are currently consistent with the Government's stated tax policy objectives?

In terms of these proposals, we believe that a large number of taxpayers will be affected when compared with the small number of situations where inappropriate tax results are currently arising. In our view, where a relatively large number of taxpayers face a significant compliance cost to deal with a relatively small number of problematic situations, it is evident that the proposals need greater focus.

As stated previously, we believe that the rules for contingencies have generally operated well, and isolated results, such as the *Collins* case, can be dealt with using directed tax changes.

Therefore, we believe that an appropriate balance would achieved by revising the proposed changes so that they are directed at situations similar to the *Collins* case. In this respect, we believe that a focused anti-avoidance rule could be directed at tax-motivated transactions that seek to take advantage of planning with contingencies. Of particular importance, this rule would have no impact on legitimate commercial arrangements that have adjustment provisions for *bona fide* reasons. In these cases, an adjustment for tax purposes should only be required when the adjustment is finalized as a commercial matter. We would be pleased to discuss this issue in more detail.

If the main concern is that arrangements similar to those in *Collins* can result in situations where tax attributes are not reduced or recaptured, then another possibility would be to apply a modified version of the draft proposals at the time the right to reduce becomes legally effective to ensure adjustments are made at that point in time.

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

Mitchell Sherman
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Ron Durand
Douglas Cannon
Elaine Marchand
Gabe Hayos

Finally, as you know, we previously provided you with a list of possible technical concerns with the proposed changes. Moreover, additional technical issues have since been identified. Because we continue to believe that the proposed changes need greater focus, we have not reviewed those in greater detail here. However, if the Department determines that it does not want to pursue a more focused approach, we urge the Department to review and discuss with us those technical concerns.

We would be pleased to discuss our comments with you in more detail.

Yours very truly,

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