The Joint Committee on Taxation of
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May 6, 2003

Mr. Len Farber
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Dear Mr. Farber:

Re: Issues for Consideration—December 20, 2002 Technical Amendments– General Provisions

We are pleased to submit the attached brief for your consideration and review. Our submission highlights a wide variety of the technical issues raised by members of the tax community in respect of the general provisions of the technical amendments contained in the December 20, 2002 draft legislation. A working group of the Joint Taxation Committee has been struck to deal separately with the proposed foreign affiliate amendments in the draft legislation. Related meetings and discussions have already taken place and a written submission by the Joint Taxation Committee in respect of the foreign affiliate amendments will follow at a later date.

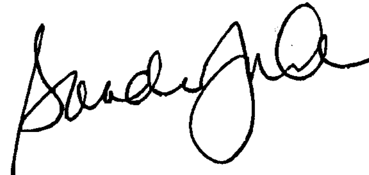
Many of the recommendations contained in the Joint Taxation Committee's March 15, 2002 submission are not reflected in the December 20, 2002 draft legislation. We understand that the reason for this was due to the timing of our submission and the Department's deadlines. This submission does not raise matters highlighted in our March 15, 2002 submission unless they were specifically addressed in the December 20, 2002 draft legislation.

While most of the issues in the submission should be self-explanatory, there is one general issue not discussed in the brief that we want to bring to the Minister of Finance's attention. Specifically, we ask the Department to carefully reconsider issuing this type of large package of omnibus technical amendments so late in the calendar year. We have previously shared our concerns over the timing of the release of such a large package of technical amendments so late in the calendar year with you and your officials and you have generally been quite supportive of our position. We understand that the Minister's office has a key role to play in decisions as to the timing of release of these types of proposals and that you and your officials may not always have the final say. Accordingly, we have written separately to the Minister of Finance to raise this important issue directly with him and have copied you on that letter.

In a somewhat related comment we also ask the Department to consider not including changes involving new tax policy directions into a large package of draft technical amendments where they can easily remain unnoticed by taxpayers for some period of time. There are at least two examples of significant expansion of the scope of taxation contained in the December 20, 2002 draft legislation: the expansion of the kiddie tax to interest and rental income and the expanded imposition of withholding tax on payments by Canadian branches of foreign corporations. Such far-reaching tax policy changes should be announced well in advance of year-end and more appropriately as part of the annual federal budget. If the Department views it necessary to incorporate selected new tax policy directions into a larger package of draft technical amendments we ask the Department to identify and highlight any such substantive proposals with significant commercial impact in a press release, backgrounder or other communication upon release of the draft legislation. This would serve to clearly put taxpayers on notice of the change as soon as it is publicly announced. Taxpayers could then react immediately to assess its potential impact on their affairs and to take appropriate action, if any, to mitigate the effect of the shift in tax policy.

We trust you will find our comments and recommendations helpful and we would be pleased to meet you and your colleagues to elaborate on any of the issues discussed in this submission or our earlier submission on technical issues of March 15, 2002.

Yours truly,



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JOINT COMMITTEE SUBMISSIONS ON DECEMBER 20, 2002 TECHNICAL AMENDMENTS

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A. Personal Taxation

A.1 Capital Gains Rollover for Small Business Investors—Expanded Continuity Rules
(*s. 44.1(6) and s. 44.1(7)***)**

Existing section 44.1 permits an individual to defer the recognition of all or a portion of a capital gain arising on a disposition of an eligible small business investment in certain circumstances. The proposed amendments to the two continuity rules in subsections 44.1(6) and (7) have the effect of expanding these rules to shares received in transactions completed under sections 51 and 86, and under subsection 85.1(1), while removing from these continuity rules shares received under subsection 85.1(3).

Presently, the preambles to both subsection 44.1(6) and (7) only contemplate shares issued by "another corporation". We are concerned, however, that transactions completed under sections 51 and 86 do not involve another corporation.

Recommendation:

We recommend that the preambles to both subsection 44.1(6) and (7) should be amended to address this concern.

A.2 Qualified Farm Property Transfers Now Subject to s. 69(11)
(*s. 73(3) and s. 73(4)***)**

Existing subsections 73(3) and (4) provide a tax-deferral on an *inter vivos* transfer of farm property, shares of a family farm corporation or an interest in a family farm partnership by a taxpayer to a child of the taxpayer. The existing rules provide that section 69 does not apply to transfers made under subsections 73(3) and (4).

Proposed amendments to subsections 73(3) and (4) only limit subsection 69(1) from applying to transfers made under subsections 73(3) and (4). As a result, subsection 69(11) may apply to transfers of qualified farm property (i.e., farmland, shares of farm companies and interests in farm partnerships) by a taxpayer to a child of the taxpayer if that property is resold by the child within three years, and one of the main purposes of the transfer was to use the child's capital gains exemption (or other deductions) on the resale. If subsection 69(11) applies the parent/taxpayer is deemed to have disposed of the property at fair market value at the time of the original transfer to the child of the taxpayer.

Recommendation:

We believe that a consequential amendment should be made to subparagraph 69(11)(a)(i) to include a reference to subsection 110.6(2) in order to allow subsection 85(3) and 98(3) to apply to qualified farm property in the same manner as it does to qualified small business corporation shares.

A.3 Definition of "Common-Law Partner" Needs Modifying (*s. 248(1)*)

Proposed amendments to the definition of "common-law partner" in subsection 248(1) include a wording change to the post-amble to the definition. A taxpayer and a person who cohabit in a conjugal relationship at any time are at any particular time after that time deemed to be cohabiting in a conjugal relationship unless they were living separate and apart at the particular time for period of at least 90 days that includes the particular time because of a breakdown of their conjugal relationship ("90 day living separate and apart" rule).

We believe that the "90 day living separate and apart" rule is difficult to understand. One possibility for this is the juxtaposition of the phrase "at the particular time" with the phrase "for a period". We understand that the CCRA's

position is that if the separation lasts at least 90 days, the deeming rule ceases to apply at the beginning of the period.

Recommendation:

We recommend that a change be made to the proposed amendments to the post-amble to the definition of "common-law partner" so that a taxpayer and a person who cohabit in a conjugal relationship at any time are at any particular time after that time deemed to be cohabiting in a conjugal relationship "unless they have lived separate and apart throughout a period of at least 90 days that includes the particular time because of a breakdown of their conjugal relationship."

A.4 New Relief to Stock Option Holders Limited to Certain Reorganizations Which Give Rise to Deemed Dividends (*Regulation 6204*)

A stock option holder who is deemed to have received an employment benefit in the year under subsection 7(1) may be entitled to a deduction equal to 1/2 of the benefit if the conditions in paragraph 110(1)(d) exist. In respect of an option agreement to acquire a share, the share must be a "prescribed share" at the time of its issue (or sale), or would have been a prescribed share if it were issued (or sold) to the taxpayer at the time the taxpayer disposed of rights under the agreement.

Regulation 6204 sets out the conditions that must exist before a share is a prescribed share for purposes of paragraph 110(1)(d). In general, the corporation cannot reasonably be expected to, within two years after the time the share is issued (or sold) redeem, acquire or cancel the share or reduce the paid-up capital (PUC) of the share. A reduction of PUC as a consequence of an amalgamation of a parent and its wholly-owned subsidiary and a wind-up under subsection 88(1) is excluded from the general rule.

Proposed amendments to Regulation 6204 are intended to expand relief to a taxpayer who acquired a share under a stock option agreement referred to in subsection 7(1) where there is a reasonable expectation that the PUC of the share will be reduced in the following two years from issue (or sale) and the reduction of the PUC of the share is the consequence of a distribution or appropriation to which subsection 84(2) applies.

The proposed amendments, in their referral to the application of subsection 84(2), are arguably unclear as to whether the relief is available in circumstances where funds or property of a corporation resident in Canada have been distributed (or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares) on the winding-up, discontinuance or reorganization of the corporation's business but the amount or value of the funds or property distributed or appropriated does not exceed the amount of any paid-up capital reduction in respect of the shares of that class on the distribution or appropriation such that a dividend is not deemed to be paid. It may be argued that in these circumstances subsection 84(2) does not apply.

Recommendation:

We recommend that the proposed amendments to Regulation 6204 be revised so that it is clear that the relief is available if the issuer is a taxable Canadian corporation and the particular transaction is one described in subsection 84(2), whether or not a dividend is deemed to have been paid. This could be effected by revising proposed Regulation 6204(1)(b)(iii) to read "a distribution or appropriation of funds or property of a corporation resident in Canada described in subsection 84(2); and".

A.5 Kiddie Tax Extended to Interest and Rental Income
(*s. 120.4*)

Proposed amendments to the definition of “split income” in the so-called “kiddie tax” replace the word “goods” in the phrase “goods or services” with the word “property”. As a result, split income would include income related to property or services provided to, or in support of, a business carried on by certain related parties. According to the Department of Finance’s explanatory notes these changes were intended to ensure “that the split income rules will apply to income from property such as rental income.”

According to clause 59(3) of the December 20, 2002 technical amendments these amendments apply in respect of fiscal periods and taxation years that begin after December 20, 2002.

Recommendation:

In order to allow taxpayers who are affected by this change an opportunity to reorganize their affairs, we recommend that transitional relief be provided to existing arrangements which would be caught by the proposed amendments to the definition of “split income”.

A.6 Proposed Amendments to Overseas Employment Tax Credit Provisions Reach Too Far
(*s. 122.3(1.1)*)

An individual Canadian resident may be entitled to claim the overseas employment tax credit (OETC) for qualifying income from overseas employment. Qualifying income is the employment income earned in the qualifying period (i.e., any period of more than six consecutive months that began before the end of the year and included any part of the year) while the individual was employed with a "specified employer", provided that all or substantially all of the individual's

employment duties were performed outside of Canada in connection with a contract under which the specified employer carried on business outside Canada on a resource, construction, installation, agricultural or engineering project (or for the purpose of obtaining such a contract).

For purposes of the OETC, a "specified employer" is a person resident in Canada, a partnership (provided that persons resident in Canada or corporations controlled by persons resident in Canada own more than 10% of the aggregate fair market value of all interests in the partnership) or a foreign affiliate of a person resident in Canada.

Proposed amendments to subsection 122.3(1.1) would restrict employees of Canadian companies from providing services to a corporation, partnership or trust with which the employer does not deal at arm's length, and the fair market value of all the issued shares of the corporation or all interests in the partnership or trust that are held by persons resident in Canada is less than 10% of the fair market value of all those shares or interests.

We understand that the proposed changes to subsection 122.3(1.1) are aimed at situations where employees of Canadian companies obtain the tax benefit of the OETC and the Canadian employers are subject to insignificant amounts of Canadian corporate tax because the employees are provided to related companies for a nominal fee above the salary of the employee. However, the proposed changes as currently drafted would give rise in some circumstances to an inappropriate result that might be considered inequitable.

As an example, Canco is wholly-owned by Parentco. Canco is a resident corporation and Parentco is a corporation resident in the US. Parentco owns another company (Sisterco) that is resident in France. The services of Canco to Sisterco are priced at fair value and accordingly an appropriate profit is earned by Canco which is subject to Canadian tax. A significant portion of the services of

Canco are performed at its offices within Canada. However, from time to time it is required that Canco's employees be "on site" at the premises of Sisterco outside Canada. Subject to satisfying the time and other requirements of the OETC provisions, these Canadian employees would be entitled to the OETC under the existing rules, as would employees of other Canadian firms providing the same services to an unrelated person. However, under the proposed amendments to subsection 122.3(1.1) the employees of Canco would not be allowed to claimed an OETC in this example.

Recommendation:

We recommend that proposed subsection 122.3(1.1) be clarified so that services of an individual will be deemed to have been provided to an arm's length person where the fees received by the employer in respect of such services are equivalent to amounts that would reasonably be expected to be received in the circumstances had the parties been dealing at arm's length.

B. Corporate Taxation

B.1 Flow-Through of Partnership Capital for LCT Purposes Where Partnership Breaks Even
(*s. 181.2(5)***)**

Under existing law, in calculating the Part I.3 tax of a Canadian resident corporation that is a member of a partnership at the end of the corporation's taxation year, the corporation's proportionate share of partnership "capital" (paragraph 181.2(3)(g)) and "investment allowance" (subsections 181.2(4) and (5)) is taken into account in determining the taxable capital of the corporation for the taxation year. The amount of capital and investment allowance of the partnership allocated to the corporate member is based on the proportion that the corporate member's share of income or loss for the partnership's fiscal year is of the partnership's income or loss for the year.

In a 1995 technical interpretation, the CCRA stated that no capital of the partnership is allocated to a corporate member where there is no income or loss of the partnership to allocate (TI #9524915). The CCRA added that these circumstances are rare and it is clear that this result was unintended. The CCRA said in the TI that it has brought this matter to the attention of the Department of Finance.

Presumably the CCRA's views in the TI would apply to deny a corporate member its share of investment allowance of the partnership under subsection 181.2(5) where there is no income or loss of the partnership to allocate.

Proposed subsection 181.2(5) is amended so the amount of investment allowance of the partnership that a corporate member may deduct in the corporation's taxation year is based on the corporate member's "specified proportion" of the investment allowance of the partnership. A partner's specified proportion of the partnership's total income or loss for the partnership's fiscal year is the partner's share. If the partnership's income or loss for the year is nil, the proportion is computed as if the partnership had $1 million of income for the year (note that the December 20, 2002 technical amendments propose to move the definition of specified proportion from subsection 206(1) to subsection 248(1)).

We are unclear why paragraph 181.2(3)(g) is not amended to include a reference to “specified proportion” to flow through the partner’s specified proportion of partnership capital.

Recommendation:

We recommend that proposed paragraph 181.2(3)(g) be amended so that a corporate member of a partnership is also allocated its specified proportion of the partnership’s capital for the year.

C. Trust Taxation

C.1 Continuity Rule Needed for Distributions of Property Received by a Partnership or Corporation on Qualifying Dispositions from Certain Trusts (*s. 107(4.2)*)

Proposed new subsection 107(4.2) applies where a corporation or partnership has transferred property to a trust in a qualifying disposition. It provides that on a subsequent distribution of the property (or substituted property) by a personal trust or a trust prescribed for purposes of subsection 107(2) to a beneficiary who is neither the particular partnership nor the particular corporation the fair market value rule in subsection 107(2.1) applies.

The December 20, 2002 technical amendments do not include continuity rules that would apply where the settlor is a corporation that has subsequently amalgamated with another corporation or has been wound up into its parent.

Recommendation:

We request an amendment to the Act to address this concern. There is no apparent reason the amalgamated corporation or the parent corporation should not be considered a continuation of the settlor for the purposes of proposed subsection 107(4.2).

C.2 New Definition of "Testamentary Trust" Too Restrictive (*s. 108*)

Proposed amendments to the definition of "testamentary trust" in subsection 108(1) will exclude from the definition a trust that incurs a debt or any other obligation to pay an amount to a beneficiary or a non-arm's length person (other than debts and obligations in respect of distributions).

We believe that these amendments are too restrictive. For example, the payment by a beneficiary of funeral expenses on behalf of an estate may taint a testamentary trust under the proposed amendment (ie., this payment may be necessary where the Will has not been probated and the estate's money cannot be accessed). The payment of expenses of a testamentary trust by a trustee who is also a beneficiary may also taint the trust under the proposed amendment.

It appears that the policy behind the proposed amendments to the definition of testamentary trust may be to stop income splitting schemes involving loans to trusts at no interest or a low rate of interest to take advantage of the fact that a testamentary trust is taxed at the graduated rates for individuals.

Recommendation:

We request that the Department of Finance confirm (or clarify) the policy behind the proposed amendments to the definition of testamentary trust. If the policy behind the proposed amendments is to stop income splitting schemes involving loans to trusts at no interest or a low rate of interest we recommend that the Department of Finance modify these amendments to include a purpose test (as in existing subsection 56(4.1)) or a prescribed interest rate test (as in existing section 74.5(2)).

In the alternative, we recommend an exception to the proposed definition of testamentary trust in subsection 108(1) for a debt or obligation incurred by a trust because a beneficiary has paid amounts on behalf of the trust and is entitled to be reimbursed.

C.3 Definition of "Designated Beneficiary" Needs Modifying (*s. 210(d)(i)*)

(i) Under the proposed amendments to the definition of "designated beneficiary" of a trust (the "Trust") in subparagraph 210(d)(i) a beneficiary of the Trust that is another trust (the "Other Trust") is a designated beneficiary if a beneficiary of the Other Trust (the "Beneficiary") is a person or partnership who would, if the person or partnership were a beneficiary of the Trust, be a designated beneficiary as a result of the application of paragraph 210(a), (b), (c) or (e). Proposed paragraph 210 (c) of this definition provides that certain tax exempt entities are designated beneficiaries of a trust if they acquire their interests in the trust from a beneficiary of the trust but are not designated beneficiaries if they acquire their interests directly from the relevant trust.

We observe that proposed subparagraph 210(d)(i) does not specify the circumstances in which the Beneficiary is considered to become a beneficiary of the Trust for purposes of determining whether the beneficiary would be a designated beneficiary of the Trust (i.e., whether the Beneficiary acquired its interest from another beneficiary or directly from the Trust).

(ii) The coming into force provision in clause 110 of the December 20, 2002 technical amendments is misnumbered. It is currently numbered clause 110(2) and it refers only to clause 110(1).

Recommendations:

(i) We recommend that proposed subparagraph 210(d)(i) should be modified to provide that the Beneficiary will be considered to have acquired its interest in the Trust in the same circumstances as it acquired its interest in the Other Trust for purposes of paragraph 210(c).

To the extent such an amendment is made, a corresponding amendment would be required to proposed clause 210(e)(i)(B).

(ii) We recommend that clause 110(2) of the December 20, 2002 technical amendments be renumbered as "110(3)" and it should refer to clauses 110(1) and 110(2).

C.4 Relief for Beneficiaries Who Acquired Their Interests in a Qualifying Exchange under the "Designated Beneficiary" Rules (*s. 210(c)*)

The definition of "qualifying exchange" in subsection 132.2 contemplates that the transferee is a mutual fund trust; however, it is possible that at some time following the completion of the qualifying exchange the transferee could cease to be a mutual fund trust. The former unitholders of the terminating fund (i.e., the transferor) would have acquired their units in the transferee (i.e., the Trust) from the transferor. Such unitholders that are, because of subsection 149(1), exempt from tax under Part I, would be designated beneficiaries of the transferee under proposed paragraph 210(c) since they acquired their units of the transferee from the transferor, which would have been a beneficiary under the transferee, and such acquisition is not one contemplated by either of proposed subparagraphs 210(c)(i) or (ii).

Recommendation:

We request that proposed paragraph 210(c) be amended to contemplate that it is permissible for the interest in the Trust to have been acquired from a beneficiary under the Trust if the acquisition occurred as part of a qualifying exchange. To the extent that such an amendment is made, consideration should be given as to whether corresponding amendments would be required to proposed clauses 210(d)(ii)(C) and (D) and 210(e)(ii)(A).

D. Eligible Capital Property

D.1 Capital Gains Election Only Available for "Acquired" ECP (*s. 14(1.01)*)

The election provided in subsection 14(1.01) was introduced with legislation to implement the February 2000 federal budget. The purpose of the election, as outlined in the Finance technical notes, was to provide taxpayers with the flexibility to recognize the gain on the disposal of ECP, other than goodwill, as a capital gain, thus allowing for the utilization of capital losses and preservation of the CEC pool balance.

The proposed amendments to subsection 14(1.01) have the effect of restricting the election to ECP that has been acquired. Under the existing rules, the election would appear to apply to any disposition of ECP (other than goodwill), whether or not that ECP was originally acquired by the taxpayer from a third party or was developed by the taxpayer in the course of its business. We understand that the CCRA does not agree with this interpretation.

The proposed technical change to the preamble to subsection 14(1.01) adds the phrase "in respect of the acquisition of… ". This addition may have the impact of restricting the election to disposals of previously acquired ECP.

There is no apparent policy reason this election should be restricted to taxpayers who dispose of ECP that has been acquired. In this respect, the proposed amendment results in an inequity for taxpayers who dispose of ECP that has been developed internally. The proposed amendments to subsection 14(1.01) also favour taxpayers who acquire ECP for a nominal cost and then develop it, with the result that the increase in value of the ECP is attributable to the enhancements rather than the initial cost, over those taxpayers who develop ECP from the outset.

Recommendation:

We recommend that the proposed changes to the preamble to subsection 14(1.01) should be modified so that the reference to "in respect of the acquisition" in the phrase "if the taxpayer's actual proceeds of the disposition exceed the taxpayer's eligible capital expenditure in respect of the acquisition of the property" is deleted.

E. Corporate Reorganizations

E.1 Definitions of "Specified Class" and "Qualified Person" Need Modifying (*s. 55(1)*)

Proposed amendments to subsection 55(1) include modifications to the definition of "specified class" and the introduction of a new definition for "qualified person". Proposed paragraph (d) in the definition of specified class and proposed paragraph (e) in the definition of qualified person include the phrase "in the event of a failure or default under the terms or conditions of the shares." We believe that the concept of shares becoming voting in the event of a "failure or default", while it currently appears in subclause 88(1)(c.8)(ii), is somewhat novel, in that it introduces debt concepts (i.e., subparagraph 212(1)(b)(vii)) into an equity context.

Proposed paragraph (d) in the definition of qualified person indicates that the exchanged shares must be shares that would be shares of a specified class, but only for their convertibility or exchangeability. We think that the corresponding portion of the Department of Finance explanatory notes is not clear and makes no reference to exchangeability.

Recommendations:

We recommend that the phrase “of the corporation” be inserted after the phrase “board of directors” in paragraph (d) in the definition of specified class, similar to the drafting of paragraph (e) of the definition of qualified person. We recommend that proposed amendments to subsection 55(1) be revised so as to clarify what is meant by a “failure or default” under share terms.

E.2 Specified Shareholder Exclusion
(*s. 55(3.4)***)**

Proposed subsection 55(3.4) will provide that shares of a specified class are to be ignored in determining whether a person is a specified shareholder for the purposes of the definition of "qualified person" in subsection (1), for the purposes of subparagraph (3.1)(b)(i) and for the purposes of paragraph (3.2)(h).

Among other things, paragraph 55(3.1)(b) restricts certain transactions by or involving transferee corporations or shares of such corporations. For this purpose, a corporation that is a specified shareholder of the distributing corporation is deemed to be a transferee corporation pursuant to paragraph 55(3.2)(h). The deeming rule in paragraph 55(3.2)(h) applies for each of subparagraphs 55(3.1)(b)(i), (ii) and (iii). However, proposed subsection 55(3.4) only modifies paragraph 55(3.2)(h) as it applies for the purpose of subparagraph 55(3.1)(b)(iii) which restricts acquisitions of share of the distributing corporation by a transferee corporation.

Because new subsection 55(3.4) does not modify the paragraph 55(3.2)(h) deeming rule for the purposes of subparagraphs 55(3.1)(b)(i) and (ii), a corporate shareholder that is a specified shareholder by virtue of owning shares of a specified class is still deemed to be a transferee corporation for the purposes of these subparagraphs. If, for example, such a corporate shareholder was subject to an acquisition of control, subparagraph 55(3.1)(b)(ii) could apply to deny the

butterfly exemption even though the corporate shareholder only held specified class shares.

In conjunction with the introduction of the qualified person definition, subparagraph 55(3.1)(b)(i) and paragraph 55(3.2)(h) are amended to exclude "qualified persons" from the application of these provisions. Paragraph 55(3.2)(h) is amended such that qualified persons that are corporations will not be deemed to be transferee corporations for the purposes of paragraph 55(3.1)(b). By amending paragraph 55(3.2)(h) directly, the amendment applies for the purposes of all of paragraphs 55(3.1)(b)(i), (ii) and (iii).

It is not clear to us why proposed subsection 55(3.4) does not modify the paragraph 55(3.2)(h) deeming rule for purposes of paragraph 55(3.1)(b).

Recommendation:

We recommend that proposed subsection 55(3.4) be amended so that it modifies the deeming rule for purposes of subparagraphs 55(3.1)(b)(i) and (ii).

E.3 Related Party Transactions
(*s. 55(3)(a)(iii)***)**

Under the existing subsection 55(3)(a)(iii), subsection 55(2) does not apply to any dividend received by a corporation if, a transaction or event or a series of transactions or events as a part of which the dividend was received, there was not at any particular time a disposition, to a person or partnership who was an unrelated person immediately before the particular time of (A) shares of the corporation that paid the dividend or (B) property more than 10% of the fair market value of which was, at any time during the course of the series, derived from shares of the dividend payer.

Proposed clause 55(3)(a)(iii)(B) is amended by including the phrase "(other than shares of the capital stock of the dividend recipient)" after the word "property".

We are concerned that it will not be obvious to most people from reading the Department of Finance explanatory notes the problem that this amendment is trying to correct. Using the example contained in the notes, we understand the problem to be that when BuyerCo purchases the shares of Target, BuyerCo will be an "unrelated person" as regards to Target immediately prior to that acquisition. The Target shares that BuyerCo acquires at that time will, later on in the series, be property that (momentarily) derives more than 10% of its value from SubCo shares, when Target owns preferred shares of SubCo. As a result, SubCo is the dividend payer, the Target shares that BuyerCo previously acquired will (later on in the series) derive more than 10% of their value from those SubCo preferred shares, and BuyerCo's acquisition of Target shares (at a time when it is an "unrelated person") thereby falls within clause 55(3)(a)(iii)(B), but for the proposed amendment.

Recommendation:

We recommend that the legislative language in proposed clause 55(3)(a)(iii)(B) be revised to more precisely clarify what is intended .

E.4 Deemed Listing on Prescribed Stock Exchange (*s. 55(6)*)

Proposed new subsection 55(6) deems a share to be listed on a prescribed stock exchange for purposes of subsection 116(6) and the definition of "taxable Canadian property" in subsection 248(1) if certain conditions are met.

Subsection 87(10) deems a share to be listed on a prescribed stock exchange not only for the purposes of subsection 116(6) and the definition of "taxable Canadian

property” in subsection 248(1), but also for purposes of the various “qualified investment” provisions.

Recommendation:

The Committee recommends that proposed 55(6) be modified so that it also applies to the definitions “qualified investment” in subsections 146(1), 146.1(1) and 146.3(1) and in section 204.

E.5 Modifications to the Exclusions from “Substituted Property” Do Not Allow Sequential Wind-Ups

(*s. 88(1)(c)(vi)***)**

Pursuant to subparagraph 88(1)(c)(vi), ineligible property includes any property distributed to the parent on the wind-up if, as part of the series of transactions or events that includes the wind-up, the property or property acquired in substitution for such property was acquired by a person or persons described in clause 88(1)(c)(vi)(B). The extended meaning of “substituted property” for the purpose of clause 88(1)(c)(vi)(B) is found in paragraph 88(1)(c.3).

The Department of Finance explanatory notes for clause 36 of the December 20, 2000 technical amendments include the following example: S Co., a taxable Canadian corporation, owns 15% of T Co, a publicly traded taxable Canadian corporation. P Co makes a takeover offer for all the shares of T Co. Before the sale to P Co, S Co transfers all of its shares of T Co to Newco in exchange for shares of Newco under section 85. The adjusted cost base and the paid-up capital of the Newco shares are then increased by the amount of the safe income attributable to the T Co shares. Subsequently S Co sells the shares of Newco to P Co for cash and Newco is wound up.

Proposed subparagraph 88(1)(c.3)(vi) ensures that a share or debt of the subsidiary is not substituted property for the purpose of clause 88(1)(c)(vi)(B) if

the share or debt was owned by the parent immediately before the wind up. As result, a bump will not be denied where a safe income crystallization involves a wind-up of Newco followed by a wind-up of T Co.

A bump could be denied where the wind up of T Co is followed by the wind up of a subsidiary of T Co and the taxpayer wants to obtain a bump of the property owned by the lower-tier subsidiary. The reason for this concern is that the amendment only protects shares of a "subsidiary" and, thus, would not protect a prohibited acquisition of these shares in analyzing the bump denial rule to a wind up of a lower tier corporation.

Recommendation:

We recommend that the Department of Finance consider drafting changes to the Act which would give sequential wind-ups of lower-tiered corporations in the above example protection from the bump denial rules in paragraph 88(1)(c).

E.6 Definition of "Disposition" Should Exclude Certain Predecessor Corporation Obligations
(*s. 248(1) and s. 248(1.1)***)**

The proposed changes to the definition of "disposition" in subsection 248(1) extend from and include 1972 to the present. The definition of "disposition" was originally contained in section 54 and then the definition was moved to subsection 248(1). The combined effect of the proposed changes in the technical amendments is to amend both provisions for the relevant periods.

Proposed new paragraph (n) of the definition of "disposition" (and proposed new subsection 248(1.1) for redemptions, acquisitions or cancellations after 1971 and before December 24, 1999) contains an exclusion which provides that the redemption, acquisition or cancellation of a share or the right to be issued a share of the capital stock of a corporation which is held by another corporation is

deemed not to be a disposition if the redemption, acquisition, or cancellation occurs as part of a merger or combination of two or more corporations including the issuing corporation and the disposing corporation to form a new corporate entity, the merger or combination is an amalgamation within the meaning of 87(1) which is not a vertical short form amalgamation within the meaning of 87(11) or the merger is a foreign merger as defined by 87(8.1) of the Act.

In addition, in order for the exclusion to apply it is necessary that the corporation that disposes of the share or right receive no consideration or in the case of the foreign merger, the disposing corporation does not receive any consideration other than property that was immediately before the foreign merger owned by the issuing corporation that on the foreign merger becomes property of the new corporation.

By specifically providing in the case of shares or rights that there is no disposition there may be a disposition of the property other than shares which is held by one predecessor corporation in another on the amalgamation. Thus there exists the risk that a gain with regard to other inter-predecessor obligations or property could arise.

Recommendation:

We recommend that the proposed amendments to the definition of "disposition" in subsection 248(1) and to subsection 248(1.1) should be extended to deem there not to be a disposition on an amalgamation of property that is a bond, debenture, note, certificate, mortgage, other debt obligation, an agreement of sale or similar property, or an interest in such property, which is held by one predecessor corporation where the "obligor" is another predecessor corporation. This would codify the administrative practice in this area a part of which is contained in IT-474R paragraph 42.

E.7 Definition of "Disposition" Should Also Exclude Vertical Short Form Amalgamations
(*s. 248(1) and s. 248(1.1)***)**

Subsection 87(11) amalgamations are specifically excluded from the exclusionary provision presumably because of the application of paragraph 88(1)(b) to vertical short form amalgamations. Thus in a vertical short form amalgamation there will be a disposition and the provisions of paragraph 88(1)(b) will apply to the shares of the subsidiary owned by the parent.

Recommendation:

We recommend that the proposed amendments to the definition of "disposition" in subsection 248(1) and to subsection 248(1.1) should be revised to exclude all amalgamations, including vertical short form amalgamations, and to eliminate paragraph 87(11)(a) which does not appear to have any policy basis.

E.8 Correct Reference in Subsection 84(7) to "In This Section"
(*s. 84(7)***)**

Subsection 84(7) contains a rule providing for dividends deemed by particular parts of the Act to have been paid at a particular time to have "become payable" at that particular time.

Subsection 84(7), by its terms, applies to "a dividend that is deemed by *this subsection* or section 84.1, 128.1 or 212.1 to have been paid". The reference to "this subsection" appears to be a typographical error. Subsection 84(7) deems no dividends to have been paid, rather the obvious reference should be to "this section".

Recommendation:

We recommend that Finance replace the reference to “this subsection” with “this section”.

E.9 Circularity Problem on Section 85 Rollover Where There is Recaptured ECP Deductions
(*s. 85(1)***)**

There is a circular computation problem for a transferor’s income inclusion for a subsection 85(1) rollover when triggering recaptured eligible capital deductions on a subsection 85(1) election.

The explanatory notes assert that the purpose for paragraph 85(1)(d.12) is to ensure no double tax results from the changes made in paragraph 85(1)(d.11) (a mechanism to trigger a transferor’s recaptured eligible capital deductions on a subsequent disposition of rolled eligible capital property by the transferee) where the transferor actually triggers recapture on the rollover. The mechanism prescribed in paragraph 85(1)(d.12) requires the deduction of the factor computed in paragraph 85(1)(d.11) from two of the variables in computing the transferor’s cumulative eligible capital for the purpose only of computing the transferor’s income inclusion under paragraphs 14(1)(a) and (b). In the formula for the factor under paragraph 85(1)(d.11), variable “F” must be computed for the transferor’s cumulative eligible capital. In arriving at a value for variable “F” in cumulative eligible capital, it is necessary to determine the transferor’s subsection 14(1) income inclusion on the transfer, if any. Since the inquiry in paragraph 85(1)(d.12) is to determine that exact amount, the mechanism appears to be circular.

Recommendation:

We recommend that the proposed legislation be amended to clarify that the factor under paragraph 85(1)(d.11) should be computed without reference to adjustments made to the transferor's income under paragraph 85(1)(d.12).

F. Resource Taxation

F.1 Renunciation of Reclassified Expenses After Flow Through Share Agreement (*s. 66(12.6)*)

Expenses incurred in a taxation year by a taxpayer in drilling or completing an oil or gas well are either Canadian exploration expenses (CEE) or Canadian development expenses (CDE). Unless an expense incurred in drilling an oil or a gas well satisfies the definition of CEE, it will be a CDE. Whether an expense will be a CEE may depend upon circumstances that occur after the end of the year. Consequently, expenses incurred in the year may initially be classified as CDE and subsequently reclassified as CEE pursuant to subsection 66.1(9) when those expenses satisfy all the conditions precedent in the definition of CEE. Subsection 66.1(9) deems such expenses to have been incurred as CEE and not CDE at the time they are reclassified, not at the time they are incurred.

The proposed amendment to subsection 66(12.6) ensures that expenses that a corporation incurs prior to entering into a flow-through agreement and which are reclassified as CEE after it enters into that agreement cannot be renounced by the corporation as CEE.

The amendment appears to be broader than necessary. The proposed amendment precludes a renunciation of all reclassified expenses including expenses that have been incurred after the agreement comes into force. As an example, a corporation

enters into a flow-through agreement in December 2003 and it has until the end of 2005 to incur expenses pursuant to the agreement. The corporation may incur expenses that are CDE in 2004 that are reclassified in 2005 as CEE. Although the corporation incurs such expenses after it enters into the agreement, it may not renounce the expenses as CEE pursuant to subsection 66(12.6).

Recommendation:

We recommend that the proposed amendment to subsection 66(12.6) be limited to disallowing the renunciation of reclassified expenses that are actually incurred prior to the date on which the flow-through share agreement is entered.

F.2 Definition of "Canadian Resource Property"—Amendments Necessary? (*s. 66(15)*)

Paragraphs (d) and (e) to the definition of "Canadian resource property" in subsection 66(15) refer to rights to a rental or royalty computed by reference to an amount or value of production from, respectively, an oil or gas well and a mineral resource in Canada. Proposed amended paragraphs (d) and (e) will require that the payer of the royalty have an interest in the oil or gas well or the mineral resource and pay 90% or more of the rental or royalty out of the proceeds of production from the well or accumulation or from production of the mineral resource.

The concept of a royalty is one in which an owner of property pays a certain amount to the royalty holder dependent upon the amount or value of oil or gas or mineral produced. Traditionally, a royalty was an amount reserved on the sale of the property. The Committee doubts whether a person who has no ownership in a property can pay a rental or royalty.

Recommendation:

We request the Department of Finance reconsider the necessity of the proposed amendments to paragraphs (d) and (e) of the definition of Canadian resource property in subsection 66(15).

F.3 Non-Arm's Length Partnerships
(*s. 66(17)***)**

Under the existing Act, subsection 66(17) provides that for purposes of paragraph 66(12.66)(d), a partnership does not deal at arm's length with a renouncing corporation where an expense is renounced by the corporation and is included in the expenses of the renouncing corporation or of another corporation which that corporation does not deal at arm's length. Subsection 66(17) provides that the partnership does not deal at arm's length with the renouncing corporation only where the conditions are satisfied.

Proposed amended subsection 66(17) does not contain the same explicit limitation. One could interpret proposed amended subsection 66(17) such that a partnership that holds a majority of the shares of a corporation controls the corporation although the conditions precedent to the application of subsection 66(17) do not exist.

Recommendation:

We suggest that proposed amended subsection 66(17) be revised so that it contains the same explicit limitation as existing subsection 66(17).

F.4 Successor Rules and Partnerships
(*s. 67(10.1) and s. 66.7(10)(j)***)**

The successor rules apply where a corporation (the "successor") acquires all or substantially all of the Canadian resource properties or foreign resource properties of another person (the "original owner"). When the conditions precedent to the application of successor rules have been satisfied, the corporation can deduct the undeducted resource expenses of the original owner against income from and proceeds of disposition of properties owned by the original owner immediately prior to their acquisition by the successor. Where there is an amalgamation of a corporation and a wholly-owned subsidiary, subsection 87(2.1) applies so that the two corporations continue to be the same corporation as each predecessor corporation and the successor corporation rules do not apply. Where an amalgamation does not satisfy the provisions of subsection 87(2.1), there is a new corporation and the successor corporation rules apply to limit the deduction by the amalgamated corporation of any undeducted resource expenses of the predecessor corporation. It is the view of the CCRA that a corporation does not have an interest in property of a partnership of which it is a partner.

Proposed subsection 66.7(10.1) will apply so that where a predecessor corporation was a member of a partnership immediately prior to the amalgamation, the amalgamated corporation may deduct the resource expenses of the predecessor against income from Canadian and foreign resource properties owned by the partnership immediately prior to the amalgamation. For this purpose, the corporation's income from the partnership is the lesser of the corporation's share of the income attributable to production from the resource properties of the partnership and the percentage of the income of the partnership equal to the percentage of the properties of the partnership that would be distributed to the corporation if the partnership were wound-up.

Proposed subsection 66.7(10.1) is virtually identical to existing paragraph 66.7(10)(j). Neither of these provisions allows the corporation to apply proceeds of disposition of the resource properties held by the partnership against successored expenses.

Recommendation:

We recommend that the Department of Finance reconsider its policy that does not permit the corporation to apply proceeds of disposition of the resource properties held by the partnership against successored expenses.

G. Charitable and Political Giving

G.1 Double Counting Problem in New Subsections 248(30) to (33) (*s. 248(30) to s. 248(33)*)

Proposed new subsections 248(30) to (33) attempt to overcome the common law requirement that for a gift to exist there must be no consideration given to the donor. There are several issues regarding the proposed subsections.

Based on the wording of proposed subsection 248(31) which defines “amount of advantage”, there is a potential double counting problem. The definition of “amount of advantage” in new subsection 248(31) refers to any property, service, compensation or other benefit received by the taxpayer *or a person not dealing at arm’s-length with the taxpayer*. It would seem, therefore, that the same benefit could be an “advantage” to more than one person.

As an example, a husband and wife jointly make a charitable contribution. The husband and wife receive a joint benefit as a result. It is not clear whether both the husband and wife each have the same advantage under new subsection 248(31). If the Department of Finance’s position is that both husband and wife

receive the same advantage in this example the same advantage will reduce the eligible amount of the gift made by not only the husband but also by the wife under proposed subsection 248(30).

Recommendation:

We recommend that proposed subsection 248(30) should be revised so that the fair market value of a contribution made by a taxpayer is reduced by the amount of advantage, if any, in respect of the contribution, except to the extent that such amount in respect of such advantage was included in determining the amount of advantage in respect of any other person.

G.2 Administrative Difficulties in Reporting "Amount of Advantage" (*s. 248(31)*)

The Department of Finance's explanatory notes say that it is intended that the Income Tax Regulations be amended to require a charitable receipt to include the calculation of an advantage or eligible amount. This would appear to represent a problem for charities since the amount of advantage as defined in proposed subsection 248(31) would include anything given to the donor or any person not dealing at arm's length with the donor by any person and not necessarily by the charity or donee. The charity may not be aware of advantages obtained by or from third parties to the gift.

Recommendation:

We recommend that the charity be required to report the amount of advantage it provided or that it knows a third party has provided if the charity knew or reasonably ought to have known (i.e., wilful blindness) about the advantage.

G.3 Timing of Valuation of Gifted Property Under New Subsection 248(30) (*s. 248(30)*)

Proposed paragraph 248(30) does not refer to the time of the valuation of the property. Many of the technical amendments to sections 110.1 and 118.1 deal with specifying the time for determining the cost or fair market value of property.

Recommendation:

We recommend that proposed paragraph 248(30) be amended to clarify the time of the calculation of the fair market value of the property. Presumably that would be at the time of the transfer of property that resulted in the gift.

G.4 Circularity in the Application of New Subsections 248(31) and (32) (*s. 248(31) and s. 248(32)*)

Proposed subsection 248(32) is intended to treat a transfer of property as a gift even though the transfer is not a gift at common law. However, it depends on the concept of the "amount of an advantage" as defined in proposed subsection 248(31) in respect of a gift. Thus, there is circularity.

In addition, the element in the common law definition of a gift to be overcome is that there be no benefit or consideration in return for the transfer of the property (ie., Friedberg, 92 DTC 6301). However, proposed subsection 248(32) as it currently reads places emphasis on the existence of an “amount” in determining whether a gift has been made.

Recommendations:

The Committee recommends that proposed subsection 248(31) be modified so that the amount of an advantage is defined with reference to a transfer of property and that, in determining if the transfer of a property is a gift, any "advantage" to the transferor as a result of making the transfer is to be disregarded if either of the conditions is met. "Advantage" would be defined as "any property, service, compensation or other benefit ... [as in subsection 248(31)] ... for the transfer".

G.5 "Intention to Make a Gift" Language Not Clear (*s. 248(32)(b)*)

Proposed paragraph 248(32)(b) uses the expression "the intention to make a gift", which the Committee believes causes interpretation difficulties. If "gift" has its common law meaning, then the paragraph is ineffective. Thus, gift must be intended to have some other meaning.

Recommendation:

We believe that the Department of Finance should not use the word "gift" in describing the intention that must be present.

G.6 Marginal Note to Proposed Subsection 248(32) Should Be Clarified (*s. 248(32)*)

The marginal note to proposed subsection 248(32) is inappropriate. The rule does not deal with an intention to give, but rather the meaning of "gift". While marginal notes cannot be referred to for interpretation purposes, it is nonetheless desirable that the marginal note more accurately reflect the rule.

Recommendation:

The Committee recommends that the marginal note to subsection 248(32) be modified so that it includes a reference to meaning of gift.

G.7 Coming-Into-Force Provision for New Subsection 248(30) to (33) Needs Modifying
(*s. 248(30) to s. 248(33)***)**

The coming-into-force provision for proposed subsections 248(30) to (33) states that they apply to "gifts" made after December 20, 2002. Since one must determine whether the rules apply before applying them, one cannot have resort to proposed 248(32) in determining if a gift has been made for purposes of the coming-into-force provision. Consequently, there must be a gift in the common-law sense for the rules to apply, which means that technically the rules can never apply to expand the meaning of a gift (although a court would probably not reach this conclusion).

Recommendation:

We recommend that the coming-into-force provision refer to transfers of property.

G.8 Application of New Subsection 248(32) Should be Restricted
(*s. 248(32)***)**

Proposed subsection 248(32) appears to apply for all purposes of the Act. In particular, it applies in connection with the deemed fair market value proceeds rule in paragraph 69(1)(b). While this makes sense where the property is transferred to a qualified donee, it may not be appropriate for other types of transfers, given that subparagraph 69(1)(b)(i) specifically contemplates the situation where consideration less than fair market value received.

Recommendation:

We recommend that proposed subsection 248(32) apply for specific purposes only (i.e., it should apply to sections 110.1 and 118.1 and subsections 127(3) and 127(4.2), and for purposes of paragraph 69(1)(b) when there is a charitable gift or a political contribtution).

G.9 Double Tax Problem for Partnerships Making Political Contributions (*s. 127(3) and s. 127(4.2)*)

New subsection 127(3) is amended to provide that the political contribution tax credit is equal to the amount of the contribution, less the "amount of advantage" in respect of the contribution. As discussed earlier, the "amount of advantage" is defined in proposed subsection 248(31). The definition appears to give rise to a potential double counting problem (see Recommendation G.1 earlier).

Subsection 127(4.2) is being amended to provide that, where a partnership has made a political contribution, the deduction under subsection 127(3) is first notionally determined at the partnership level and, for the purpose of determining the amount deductible by a partner, the partner is deemed to have made a contribution equal to his or her share of the notional amount determined for the partnership.

Where a partnership makes a contribution and a partner receives a benefit as a result, it would seem that the combination of subsections 127(3) and (4.2) would require the partner to reduce his or her allocated subsection 127(3) deduction by the amount of the advantage. This may result in double counting if the partner who receives the benefit does not deal at arm's-length with the partnership.

As an example, husband and wife are sole partners in a partnership that makes a contribution and the husband receives a benefit outside the partnership. The

benefit could arguably be deducted two times – once under subsection 127(3) in determining the notional amount at the partnership level and once when determining the amount deductible by the husband in respect of his allocated share of the notional amount.

Recommendation:

The Committee recommends that proposed subsection 127(3) should be revised so that the monetary contribution made by the taxpayer to a registered party is reduced by the amount of advantage, if any, in respect of the contribution, except to the extent such amount in respect of such advantage was included in determining the amount of advantage in respect of any other person or any other partnership.

G.10 Formulas in New Subsections 110.1(3) and 118.1(6) Need Clarification (*s. 110.1(3)*)

Existing subsection 110.1(3) is now divided into two subsections, proposed subsections 110.1(2.1) and (3). The coming into force provision provides that the amendments to existing subsection 110.1(3) are effective for gifts made after 1999 and it makes an adjustment for the reference to subsection 248(30) for gifts made before the announcement date. This adjustment is necessary since the coming into force of the amendments to subsection 110.1(3) predates the coming into force of subsection 248(30).

The formula used to determine the appropriate amount of the gift in proposed paragraph 110.1(3)(a) applies in the case of a gift made after December 20, 2002 (ie., announcement date). Therefore, for gifts made prior to December 20, 2002 the amount in paragraph 110.1(3)(a) cannot be calculated and it is presumably nil.

Recommendation:

We recommend that adding the phrase "and in all other cases, nil" to proposed paragraph 110.1(3)(a) would clarify this point. The same change is recommended to proposed paragraph 118.1(6)(a).

H. Tax Exempt Entities

H.1 Proposed Subsection 149(1.3) May Create Significant Uncertainty (*s. 149(1.3)*)

Section 149 provides that no tax is payable under Part I of the Act on the taxable income of a person for a period in a taxation year when that person was a person described in section 149. Existing subsection 149(1.3) is to be revamped to provide that paragraphs 149(1)(d) to (d.6) do not apply to exempt a person's taxable income in two cases.

In the first case, proposed paragraph 149(1.3)(a) refers to a corporation the shares of which are owned by one or more persons that, in total, give them more than 10% of the votes that could be cast at a meeting of shareholders of the corporation, other than shares owned by Her Majesty in right of Canada, or of a province; a municipality in Canada; or a commission, an association or a corporation, to which any of paragraphs 149(1)(d) to (d.6) apply.

The wording of proposed paragraph 149(1.3)(a) is ambiguous. As an example, a corporation (Corp) has 100 shares outstanding. Ninety of the outstanding shares of Corp are owned by Her Majesty and 10 shares are owned by another person. If "other than shares" in proposed paragraph 149(1.3)(a) means shares owned by Her Majesty are not taken into account then the remaining shares will be owned by "other persons" who will own 100% of the votes of the remaining shares. We

do not believe that this is the result intended by the Department of Finance.

Recommendation:

We recommend a clarification to paragraph 149(1.3)(a) to confirm what is intended.

H.2 Onus on Charity to Confirm "Qualified Donee Status" (*s. 149.1(2)(c)(ii), s. 149.1(3)(b.1)(ii) and s. 149.1(4)(b.1)(ii)*)

Proposed new subparagraphs 149.1(2)(c)(ii), 149.1(3)(b.1)(ii) and 149.1(4)(b.1)(ii) allow the Minister of National Revenue the discretion to revoke the registration of a charitable organization, public foundation or private foundation if any such entity makes a gift (other than a gift made in the course of carrying on its charitable activities) to a donee that is not "a qualified donee at the time of the gift." A registered charity may be unable to confirm the qualified donee status of a proposed donee at the time of the gift in which case the registration of the donor would be unduly jeopardized.

A registered charity may be unable to determine the qualified donee status of a proposed recipient at the time of gift because of a variety of practical limitations. A print version of a list of all qualified donees (including registered charities, those listed in Schedule VIII and others) is not readily available to registered charities and is current only to the date of publication. Although a list of registered charities is available under "charities" on the CCRA's website, many charities do not have access to the internet. Also, charities that have internet access could inadvertently make a gift to an entity that was not a qualified donee if this list is not updated immediately upon the revocation of a charity's registration (the list is currently updated weekly) or the charity making the gift checked the website the day before revocation and payment of the gift.

Many charities rely on volunteers to perform some or all of their administrative and other responsibilities and, as a result these charities may not have the resources or expertise to confirm the qualified donee status of a proposed recipient of a gift and do so immediately before the making of the gift.

Recommendation:

We recommend that proposed subparagraphs 149.1(2)(c)(ii), 149(3)(b.1)(ii) and 149.1(4)(b.1)(ii) be clarified so that the Minister of National Revenue is allowed the discretion to revoke the registration of a charitable organization, public foundation or private foundation if any such entity makes a gift (other than a gift made in the course of carrying on its charitable activities) to a donee that is not "qualified donee at the time of the gift", only if the charitable organization, public foundation or private foundation knew or reasonably ought to have known (i.e., wilful blindness) that the donee was not a qualified donee at the time of the gift.

H.3 Drafting Fixes Needed to "Charitable Organization" and "Public Foundation" Definitions
(*s. 149.1(1)***)**

Proposed amendments are made in the December 20, 2002 technical amendments to the definitions of "charitable organization" and "public foundation" in subsection 149.1(1). Except for the references to "organization" and "foundation" respectively, the wording in paragraph (c) of the definition of "charitable organization" and in paragraph (a) of the definition of "public foundation" should be identical, but are not in some instances. The apparent drafting irregularities are the following.

a) Proposed paragraph (c) of the definition of "charitable organization" in subsection 149.1(1) states that "more than 50% of the directors, trustees, officers, <u>or</u> like officials of which deal with ..." (underlining added).

b) Paragraph (a) of the definition of "public foundation" in subsection 149.1(1) states "of which more than 50% of the directors, trustees, officers, and like officials …." (underlining added).

c) Subparagraph (a)(ii) of the definition of "public foundation" in subsection 149.1(1) states "…. described in paragraph 149(1)(l)),"

d) Subparagraph (b)(i) of the definition of "public foundation" in subsection 149.1(1) states "by a person that has contributed or otherwise paid into the foundation more than 50% of the capital of the organization …" (underlining added).

Recommendations:

We recommend the following to correct apparent drafting irregularities.

a) The underlined word "or" in paragraph (c) of the definition of "charitable organization" should be replaced by the word "and". We note that "and" is used in the preamble of paragraph (a) of the definition of "public foundation."

b) The underlined words "of which" may be better placed after the word "officials", as they are in the preamble of paragraph (c) of the definition of "charitable organization".

c) The word "and" should be added after the comma at the end of subparagraph (a)(ii), as it is after subparagraph (c)(ii) of the definition of "charitable organization.

d) The underlined word "organization" in subparagraph (b)(i) of the definition of "public foundation" should be replaced by the word "foundation."

H.4 New Definition of "Public Foundation" Coming-Into-Force Provision (*s. 149.1(1)*)

Subclause 88(12) of the December 20, 2002 technical amendments states "Subsection (4) applies after 1999 except that, in respect of a charitable organization that was not …, paragraph (b) of the definition "public foundation" in subsection 149.1(1) of the Act, as enacted by subsection (1), is in its application before 2005 to be read …" (underlining added).

Recommendation:

We recommend that the underlined words "charitable organization" should be changed to "foundation". The transitional period in respect of the change in the capital contribution element of the test from 75% to 50% for the foundations described in the application section should apply to the requirement under proposed subparagraph (a)(ii) of the definition of public foundation as well as proposed paragraph (b) of that definition. Thus, we recommend that the words "subparagraph (a)(ii) and" should be added immediately before the underlined words "paragraph (b).

I. Labour-Sponsored Venture Capital Corporations

I.1 Ontario LSVCC Law Does Not Have Class A Redemption Restrictions (*s. 204.81(1.1)*)

As a condition of registration under the Act, the articles of incorporation of a labour-sponsored venture capital corporation ("LSVCC") must contain certain provisions including, in general terms, a provision that a LSVCC incorporated after March 5, 1996 must not redeem a Class A share (in respect of which an information return was issued) until after 8 years after the Class A share was issued (existing clause 204.81(1)(c)(v)(E)).

In 2001, Ontario introduced legislation which amended the *Community Small Business Investment Funds Act* by repealing the requirement for the articles of a fund to contain restrictions on the redemption of Class A shares; however, a penalty tax continues to apply if a Class A share is redeemed prior to the 8th anniversary of its issuance. To address the issue dealt with by Clauses 108 and 113 of the December 20, 2002 technical amendments, the Ontario legislation provides that a Class A share that is issued in February or March that is redeemed in February or on March 1, will be deemed to be redeemed on March 31. This rule is much simpler than the proposed federal amendment.

Recommendation:

We recommend that the Department of Finance consider amending the Act so that the requirement for the articles for federally-registered LSVCC to contain restrictions on the redemption of Class A shares be removed as condition of registration.

I.2 Alternative Technique to Grandfather Class A Share Terms of Existing LSVCCs
(*s. 204.81(1.2)***)**

Proposed new subclause 204.81(1)(c)(v)(E)(II) facilitates the earlier redemption of Class A shares of a federally-registered LSVCC by taxpayers who redeem the Class A shares on a date that is in February or March 1st and not more than 31 days before the 8-year anniversary date. Under proposed new subsection 204.81(1.2) the articles of federally-registered LSVCCs will now be required to contain provisions that track the wording of proposed subclause 204.81(1)(c)(v)(E)(II). Such corporations are given until 2004 to amend their articles of incorporation to comply with the new provision. Until 2004, the articles of a federal fund will be deemed to contain such provision.

Recommendation:

At a minimum (see Recommendation in I.1), we recommend that proposed subsection 204.81(1.2) be modified so that only LSVCCs incorporated after the date of Royal Assent will be required to contain articles with Class A share conditions that match the wording of new subclause 204.81(1)(c)(v)(E). LSVCCs incorporated prior to that date whose articles comply with the current wording would be deemed to be in compliance rather than being required to amend their articles (which in turn requires shareholder approval).

I.3 Early Redemption of LSVCC Class A Share—Wording Modifications (*s. 204.81(1)(c)(v)(E)(II) and s. 211.8(1)(a)(i.1)*)

Under existing rules, if a Class A share is issued after March 5, 1996 and is redeemed prior to its 8th anniversary date, the holder of the Class A share is liable to pay a tax under section 211.8. Under proposed new subparagraph 211.8(1)(a)(i.1) this tax will not be payable if the redemption occurs in February or March 1 of a calendar year as long as such date is not more than 31 days before the day that is eight years after the day on which the share was issued.

Recommendation:

The wording of proposed subparagraph 211.8(1)(a)(i.1) is preferred to the wording in proposed subclause 204.81(1)(c)(v)(E)(II) and, thus, we recommend that the wording of both proposals be conformed.

J. Integration

J.1 RDTOH Double Taxation Concern for Foreign Investment Income (*s. 129*)

The definition of "refundable dividend tax on hand" (RDTOH) includes three components for a corporation that is a Canadian-controlled private corporation (CCPC). Under the existing definition of RDTOH, if a CCPC claims foreign non-business income tax credits under subsection 126(1), the refundable portion of Part I tax is reduced significantly. As the figure titled "Income Tax Payable on $10,000 of Foreign Investment Income Earned Through a Corporation and Directly, Ontario-Resident Individual and Corporation" in *Canadian Tax Highlights* (February 2003, Volume 11, Number 2) illustrates (reproduced below), the tax cost of earning foreign non-business income through a CCPC increases as the foreign tax rate increases.

Income Tax Payable on $10,000 of Foreign Investment Income Earned Through a Corporation and Directly, Ontario-Resident Individual and Corporation			
	Foreign non-business income tax credit		
	10%	15%	25%
	dollars		
Existing legislation			
Corporate tax	4,829	4,829	4,829
Refundable tax	(1,926)	(1,555)	(815)
Individual tax on dividend	2,224	2,108	1,876
Combined tax	5,127	5,382	5,890
Individual tax (including withholding tax)	4,641	4,641	4,641
Tax cost with Holdco	486	741	1,249
Tax deferral with Holdco	(188)	(188)	(188)
Proposed legislation			
Corporate tax	4,829	4,829	4,829
Refundable tax	(1,778)	(1,333)	(444)
Individual tax on dividend	2,178	2,038	1,760
Combined tax	5,229	5,534	6,145
Individual tax (including withholding tax)	4,641	4,641	4,641
Tax cost with Holdco	588	893	1,504
Tax deferral with Holdco	(188)	(188)	(188)
Net increase in overall tax under proposal	102	152	255

Note: The figures assume that (1) the individual is taxed at the top marginal tax rate, (2) Holdco earns only foreign investment income, (3) the taxable dividend paid is the net after-tax amount, and (4) for the 25% column, the foreign non-business income taxes relate to a disposition of real property so that subsection 20(11) does not restrict the individual's credit.

Proposed changes to the definition of RDTOH modify the adjustments that reduce the RDTOH addition for foreign non-business income. First, subparagraph 129(3)(a)(i) is being amended to replace the reference to 9 1/3% with a reference to 3 1/3%. According to the Department of Finance explanatory notes, this change is intended to reflect an assumed tax rate of 30% on a CCPC's foreign non-business income.

The second change to the adjustments to the RDTOH that reduce the RDTOH addition for foreign non-business income of a CCPC is the proposed amendment to subparagraph 129(3)(a)(ii). This subparagraph is amended to replace the reference to 25/9 in the factor for non-business income foreign tax credits with 10/3.

We are not clear why the proposed changes to the definition of RDTOH to modify the adjustments that reduce the RDTOH for foreign non-business income are needed. As the figure above illustrates, foreign non-business income is taxed at even higher integrated tax rates as a result of the proposed changes.

Recommendation:

We recommend that the formula in the RDTOH definition be modified to eliminate/reduce the element of double taxation associated with earning foreign non-business income in a CCPC.

K. Insurance Business

K.1 Concern That Subsections 138(2) and (9) Not a Complete Code With Respect to the Inclusion of Investment Income in a Non-Resident Insurer's Income (*s. 132(2) and s. 132(9)*)

In *Munich Reinsurance Company (Canada Branch) v. The Queen,* [2002] 1 CTC 1999, the Federal Court of Appeal stated that subsection 138(9) was not a complete code with respect to the inclusion of investment income in a multinational insurer's income from carrying on an insurance business in Canada.

Proposed amendments to subsection 138(2) apply to multinational insurers resident in Canada. These amendments appear to respond to the *Munich* decision and provide that subsection 138(9) is a complete code for allocating investment income.

We believe there is concern that a similar clarification has not been provided for non-resident insurers to whom subsection 138(9) also applies.

Recommendation:

We recommend that amendments be made to the Act to provide for clarification that subsection 138(9) is a complete code for allocating investment income for non-resident multinational insurers.

K.2 The Words "For Greater Certainty" Should be Removed from Subsection 132(2) (*s. 132(2)*)

Proposed subsection 132(2) provides, in effect, that a resident multinational life insurer is not subject to tax in Canada on its income from carrying on its insurance business outside Canada, and it further restricts the life insurer's gross investment reserve and capital gains that are subject to tax in Canada. The

preamble to proposed subsection 132(2) commences with the words "for greater certainty". However, we note that the rules in subsection 132(2) are operative rules, not rules that simply provide for greater certainty.

Recommendation:

We recommend that the words "for greater certainty" be removed from proposed subsection 132(2).

K.3 Relief Provided to Claims Reserves Should be Extended to Unearned Premium Reserves
(*s. 181.3(3)(c)(vii) and s. 181.3(3)(d)(iv)(F)***)**

Proposed new subparagraph 181.3(3)(c)(vii) and clause 181.3(3)(d)(iv)(F) ensure that the amount included in the taxable capital of property and casualty insurers as claims reserves is limited to the non-deductible portion of claim reserves which are not recoverable through reinsurance.

It is not clear why the language is limited to claims reserves. We believe that the same principle should apply to unearned premium reserves.

Recommendation:

We recommend that the amount included in the taxable capital of property and casualty insurers in respect of unearned premium reserves be restricted to the non-deductible portion of unearned premium reserves not recoverable through reinsurance.

L. Partnerships

L.1 Partnerships – Timing of ACB Adjustments Needs to be Further Clarified (*s.53(1)(e) and 53(2)(c); s. 99(1), s. 96(1.01)*))

The CCRA announced its revised position on the timing of additions to the adjusted cost base ("ACB") of partnership interests by virtue of a partner's share of partnership income for a particular fiscal period in *Technical News* No. 5.[1] In that announcement, it withdrew its prior position that adjustments are made "at the end of a partnership fiscal period" and announced that adjustments to ACB for such items as income[2] would only occur for "fiscal periods ending before the particular time" as prescribed by the language of the specific subparagraphs in subsection 53(1). The CCRA announced at that time that it would consider requests for opinions and rulings on specific proposed transactions to eliminate double taxation resulting from its position.

The policy of only increasing partnership interest ACB after the partnership's fiscal year-end can result in a number of problems, including with respect to partners who cease to be partners in a fiscal period, partnerships that cease to exist, partnerships that make distributions during a fiscal period and transfers of partnership interests at times other than immediately after the fiscal year-end.

The technical amendment announced on December 20, 2002 appears to address the concern for partners who cease to be members of a partnership during a fiscal period of a partnership (proposed subsection 96(1.01)), but does not appear to clarify the treatment of partners' paragraph 53(1)(e) adjustments relating to events occurring "before that time" in the last fiscal period of a partnership ending immediately before dissolution. In addition, proposed subsection 96(1.01) does

[1] July 28, 1995.

[2] Similar issues result from the attempted addition of amounts deemed by subsections 66.1(7), 66.2(6) or 66.4(6) to a partner's ACB where only such amounts in respect of fiscal periods of the partnership "ending before that time" are added pursuant to subparagraph 53(1)(e)(viii). The CCRA states in Technical News No. 12 (February 11, 1998) that it will consider relief under advance tax rulings in these circumstances as well.

not appear to contemplate other ACB adjustments (such as those for resource expenses in subparagraph 53(1)(e)(viii)) for departing partners. In essence, the position taken by the CCRA means that it will narrowly interpret and strictly enforce the words contained in paragraph 53(1)(e) as a general audit procedure but will retain the discretion to exercise its authority in what it considers appropriate circumstances to issue rulings. This enables the CCRA to effectively control the occasions where taxpayers involved in such reorganizations are subjected to double taxation and when they are not. We submit that it is unfair to taxpayers and inconsistent with general tax policy to require a taxpayer to submit to the advance rulings process to avoid an inappropriate double taxation result. It also places the CCRA in the difficult position of adopting conflicting positions on the same technical issue.

Central to this dilemma with dissolving partnerships are the problems created by the words "ended immediately before that time" in respect of a deemed year-end of a partnership on its dissolution.

Subsection 99(1) provides:

> Except as provided in subsection (2), where, at any time in a fiscal period of a partnership, the partnership would, but for subsection 98(1), have ceased to exist, the fiscal period shall be deemed to have ended immediately before that time.

The language in subsection 99(1) itself raises uncertainty as to whether or not a dissolving partnership has a deemed fiscal period ending under that subsection in all circumstances, or only in the circumstances where subsection 98(1) applies to deem the continued existence of a partnership until all partnership property has been distributed. It is possible that a partnership's fiscal year ends on dissolution as a matter of accounting practice, however this convention is not entirely clear. Certainly, subsection 99(1) could be clarified to provide for the deemed partnership year-end *notwithstanding* the application of subsection 98(1), if that is the actual intention.

Partnership year-ends on dissolution have the same timing concern addressed by proposed subsection 96(1.01) for departing partners. An illustration of one such occurrence can be found in subsection 98(3), which contains the rollout rules for dissolving partnerships where each of the partners takes an undivided interest in the partnership property. Paragraph 98(3)(a) requires partners to compute the proceeds of disposition of their partnership interest based on the greater of their ACB in that interest "immediately before the particular time [dissolution]" and the aggregate of money received and the cost of that partner's share of partnership property.

The obvious dilemma in this situation is where subsection 99(1) applies to deem a partnership year-end "immediately before dissolution", a particular partner's ACB of its interest "immediately before dissolution" may not be adjusted pursuant to paragraph 53(1)(e) for certain amounts described in that provision. For example, no adjustment would be made for the partner's share of income from the partnership in respect of its last fiscal period since subparagraph 53(1)(e)(i) makes that adjustment only for fiscal periods ending "before that time".

Recommendations:

We recommend that the treatment contemplated in proposed paragraph 96(1.01)(b) be extended to all ACB adjustments in paragraphs 53(1)(e) and 53(2)(c). Further, the language in subsection 99(1) should be clarified to deem the end of a fiscal period immediately before *all* partnership dissolutions and that the language comparable to that found in newly proposed paragraph 96(1.01)(b) (expanded as we recommend above) be added to subsection 99(1) so as to adjust fully and properly the ACB of a partner's interest for events arising in a partnership's last fiscal period, including at the time such fiscal year ends.

M. Miscellaneous

M.1 Eligible Funeral Arrangement Amendments Do Not Allow Tax-Free Transfer to Spouse
(*s. 148.1(4) and s. 148.1(5)***)**

Proposed new subsection 148.1(4) applies when an amount is transferred from one eligible funeral arrangement (EFA) account (transferor EFA account) to another EFA account (recipient EFA account) of the same or another person. The amount transferred from the transferor EFA account to the recipient EFA account will now be included in income to the extent that it does not exceed the income accumulated in the transferor EFA account.

Proposed new subsection 148.1(5) provides an exception to the rule in proposed subsection 148.1(4). Proposed subsection 148.1(4) will not apply if the transferor and the recipient EFA accounts are held by the same individual, the amount that is transferred, credited or added to the recipient EFA account is equal to the balance in the transferor EFA account immediately before the particular time, and the transferor EFA is terminated immediately after the transfer.

The exception in subsection 148.1(5) is too restrictive because it does extend to situations in which the recipient EFA account is held by the spouse of the transferor.

Recommendation:

We recommend that the exception in proposed subsection 148.1(5) be expanded to situations involving the transfer of an amount from a transferred EFA account by a taxpayer to a recipient EFA account of the spouse of the taxpayer. The exception should apply to both *inter* vivos spousal transfers and transfers at death.

If unrestricted *inter-vivos* spousal transfers are not allowed in general as an exception, we recommend that, as a minimum, a rollover should be allowed for transfers arising from marital breakdown.

M.2 Capital Loss Carryforwards Discretionary Adjustments (*s. 111(1.1)*)

Existing subsection 111(1.1) determines the amount that a taxpayer may deduct in respect of a net capital loss claimed under paragraph 111(1)(b). In general, subsection 111(1.1) adjusts capital losses carried forward for changes in the capital gains inclusion rate for the year in which the loss arose and the year in which it is claimed.

According to the Department of Finance’s explanatory notes, proposed new paragraph 111(1.1)(c) will allow the Minister of National Revenue to determine a reasonable amount of deduction in respect of net capital loss carryovers where the other rules in that subsection produce inappropriate results. However, the provision specifically refers to "the amount, if any, that the Minister determines to be reasonable in the circumstances, after considering the application of subsections 104(21.6), 130.1(4), 131(1) and 138.1(3.2) to the taxpayer for the particular year."

Proposed paragraph 111(1.1)(c) allows the Minister to determine what it considers to be a reasonable amount for the loss carryforward.

Recommendation:

We recommend that the proposed paragraph 111(1.1)(c) be revised so that it does not allow the Minister of National Revenue to determine a reasonable amount of deduction in respect of net capital loss carryovers. We also recommend that proposed paragraph 111(1.1)(c) specify that the amount, if any, that is reasonable

in the circumstances is identified in a "notice of determination" issued to the taxpayer so that the taxpayer has a legal right to challenge the Minister's determination of what is reasonable in the circumstances.

M.3 Minister's Discretion to Refund Excessive Tax Instalments (*s. 164(1.51) and s. 164(1.52)*)

Proposed new subsections 164(1.51) and (1.52) give the Minister of National Revenue the discretion to refund excessive tax instalments under the Act if certain conditions are met Under proposed subsections 164(1.51) and (1.52) the Minister may refund excessive instalments if the taxpayer has paid under any of sections 155 to 157 one or more tax instalments in respect of taxes payable under the Act in a year, it is reasonable to conclude that that the total amount of intalments exceeds taxes that will be payable by the taxpayer for the year, and the Minister of National Revenue is satisfied that the instalment payments has caused or will cause undue hardship to the taxpayer.

We submit that it is desirable to have the taxpayer consent to a refund under proposed subsection 164(1.52) because interest can potentially run if the refund results in a tax deficiency for the year. Although proposed subsections 164(1.51) and (1.52) appear to contemplate that the refund would be with the consent of the taxpayer, this should made explicit.

Recommendation:

We recommend that proposed subsections 164(1.51) and (1.52) be amended so that it requires the taxpayer to request the Minister to consider a refund request. We also recommend that proposed subsections 164(1.51) and (1.52) be amended to impose on the Minister a requirement to act with all due dispatch to consider the refund request.

M.4 Timing of Income Inclusion for GST Input Tax Credit Gives Rise to Administrative Complexity
(*s. 248(16)*)

Proposed amendments to subsection 248(16) in general require that taxpayers who claim GST input tax credits in a year subsequent to the year in which the amount became eligible to be claimed will be required to amend their income tax returns in respect of the eligible year in order to include GST input tax credits into income as government assistance.

As an example, a taxpayer made a purchase in February 2002. Under the *Excise Tax Act*, the taxpayer has 4 years (or 2 depending upon the taxpayer's annual threshold) to claim the corresponding input tax credit. Under the existing rules, the taxpayer would take the amount into income as government assistance in the year in which the amount is claimed. Under the proposed amendments to subsection 248(16), the taxpayer would be required to account for the amounts in 2002.

The proposed amendments to subsection 248(16) create unnecessary complications and administrative costs for taxpayers. Taxpayers do not receive interest for delayed input tax credits and most taxpayers desire to get their cash as quickly as possible and do not delay claiming the GST input tax credit. To now penalize taxpayers by making them amend prior income tax returns seems unduly harsh and unnecessary.

Recommendation:

We recommend that the Department of Finance reconsider the approach set out in proposed subsection 248(16) to achieve what is intended in light of the complications and administrative costs for taxpayers that these changes would give rise to .

M.5 Proposed Subsection 212(3.2) Transitional Relief (*s. 212(13.2)*)

Under existing subsection 212(13.2), payments by a non-resident person (which are deductible in computing the non-resident's taxable income earned in Canada) to another non-resident person are subject to the application of Part XIII withholding tax only if the non-resident payer carries on its business principally in Canada, manufactures or processes goods in Canada or carries out specific resources activities in Canada.

The proposed changes to subsection 212(13.2) would broaden its application. Under proposed subsection 212(13.2), any payments or credits made by one non-resident to another that are deductible in computing the paying non-resident's taxable income earned in Canada would be subject to withholding tax, unless the payments or credits relate to a treaty-protected business or property.

Proposed subsection 212(13.2) would apply to amounts paid or credited after December 20, 2002. This clearly has an unfavourable impact on financing arrangements negotiated and concluded by non-residents before the Announcement Date. If the non-residents had known the non-resident borrower would be deemed by proposed subsection 212(13.2) to be resident in Canada for purposes of Part XIII, the non-residents might instead have negotiated the terms of the financing arrangement so as to benefit from the exemption provided by subparagraph 212(1)(b)(vii) or to include a "gross-up" clause in the agreement. Alternatively, the non-resident borrower may have obtained financing from a Canadian financial institution in order to have avoided the Part XIII tax, notwithstanding the proposed changes to subsection 212(13.2).

Because of the commercial sensitivity of applying new rules to pre-existing financing arrangements and because of the significant cost of altering such financing arrangements, the Act contains many examples of grandfathering rules

and transitional rules enacted to ameliorate the harsh effect of applying new rules to existing financing arrangements.

Recommendations:

We recommend that amounts paid or credited as interest on indebtedness entered into or issued before the effective date of proposed subsection 212(13.2) be excluded from the application of proposed subsection 212(13.2).

We also recommend that proposed subsection 212(13.2) apply to amounts paid or credited after Royal Assent of the December 20, 2002 technical amendments (or a date subsequent to Royal Assent) to allow taxpayers and their advisors more time to react to proposed subsection 212(13.2).

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