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

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December 20, 2004

Mr. Brian Ernewein
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada
17th Floor, East Tower,
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Dear Mr. Ernewein:

Re: Issues for Consideration – February 27, 2004 Technical Amendments

We are pleased to submit the attached brief for your consideration and review. Our submission highlights a variety of technical issues raised by members of the tax community in respect of the February 27, 2004 Draft Technical Amendments (the "2004 Proposals").

In particular, please note that a major focus of this submission is detailed commentary on the proposed amendments with respect to the restrictive covenant provisions that were first announced in a Department of Finance Press Release on October 7, 2003.

The Joint Taxation Committee (the "Committee") submitted its comments and recommendations with respect to the December 20, 2002 Draft Technical Amendments (the "2002 Proposals") on May 6, 2003. We note many of the proposed provisions of the 2002 Proposals have been carried over to the 2004 Proposals without reflecting the Committee's recommendations. We believe our earlier comments continue to be valid. This submission does not repeat our earlier recommendations, however, we ask you to reconsider them. We attach a copy of the May 6, 2003 submission for your reference.

We trust you will find our comments and recommendations helpful and we would be pleased to meet with you and your colleagues to elaborate on any of the issues discussed in this submission or our earlier submission on technical issues of May 6, 2003.

Yours truly,

Paul B Hickey Brian Carr

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JOINT COMMITTEE SUBMISSIONS ON FEBRUARY 27, 2004 TECHNICAL AMENDMENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

A. Restrictive Covenants

Background

Proposed amendments to sections 6, 12, 56, 60, 68 and 212 and the proposed introduction of new section 56.4 to the Act contained in the February 27, 2004 Draft Technical Amendments (the “2004 Proposals”) address the treatment of payments for restrictive covenants. These amendments are further to the Press Release and Backgrounder of October 7, 2003 (the "Press Release Date"). The Press Release indicated that the proposed changes were in response to the decision of the Federal Court of Appeal in *Manrell* v. *The Queen* 2003 DTC 5225. In several material respects the amendments contained in the 2004 Proposals are significantly broader than either the Press Release or the Backgrounder indicated, including changes that were not suggested in those documents.

In general terms, the Press Release and Backgrounder indicated that, subject to limited grandfathering for existing arrangements, from the Press Release Date payments for restrictive covenants would be treated as ordinary income, except to the extent that they relate to goodwill transferred on the sale of a business or to amounts that the covenanter would have received in the form of increased proceeds of disposition of shares or a partnership interest had the covenant been granted for no consideration. The Press Release and Backgrounder thus indicated an intention to return more or less to the interpretation CRA applied to the Act prior to the *Manrell* decision, as set out in comments in Interpretation Bulletins IT-143R3 and IT-330R and elsewhere.

Our principal concerns with respect to the 2004 Proposals related to restrictive covenants are as follows:

A.1 New Definition of "Restrictive Covenant" Needs Modifying
(s. 56.4(1))

The proposed definition of "restrictive covenant" in subsection 56.4(1) means an arrangement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer (other than an arrangement or undertaking for the disposition of the taxpayer's property), that affects, in any way whatever, the acquisition or provision of property or services by a taxpayer or by another taxpayer that does not deal at arm's length with the taxpayer.

We believe that this definition is too broad and could apply to a wide range of commercial contracts. In addition, the scope of the parenthetical exception to the definition for arrangements or undertakings other than for the disposition of the taxpayer's property is considered to be too narrow. For example, as presently worded, payments under "take or pay" contracts, payments for exclusive distributorship or franchise arrangements, referral fees or other similar items may fall into this definition and be treated as restrictive covenants. Income in respect of all these items would be taxable under section 9 (or perhaps a related provision, such as paragraph 12(1)(a)), with deductions allowed for relevant expenses in accordance with the Act. There is no suggestion that the proposed amendments are intended to alter the application of the Act to such transactions, but they may do so.

If arrangements that would otherwise be included in income under section 9 are now included in income under 56.4(2) then the timing of the recognition of the income may be altered. If the arrangements that would otherwise be included in income under section 9 are now to be included in income under subsection 56.4(2) then it should be made clear that where the amounts in question otherwise constitute income from business or property, the proposed amendments do not affect this status.

Recommendation:

We recommend that the definition of "restrictive covenant" be revised so as to clarify exactly what types of arrangements are included in the definition and what types of arrangements are excluded. We also recommend that the proposals not apply to amounts that are otherwise required to be included in computing income for purposes of the Act. This would best be accomplished by limiting the application of the proposed amendments to amounts not already included in income.

If it is decided that amounts that would otherwise be included in income under section 9 are now to be included in income under subsection 56.4(2) then it should be made clear that the status of the income as constituting income from a business or property has not changed.

A.2 Non-Application of Section 42
(s. 56.4(5))

Proposed subsection 56.4(5) provides that section 42 will not apply to an amount received or receivable in respect of a restrictive covenant. While this approach appears consistent with the general approach taken in the proposed amendments, it is considered that having section 42 apply in priority to the proposed amendments would be consistent with the purpose of the proposed amendments to tax amounts not otherwise taxable under the current provisions of the Act.

Recommendation:

Proposed subsection 56.4(5) is not necessary if the proposed amendments only apply to amounts that are not otherwise required to be included in income under the Act and therefore should not be included in the proposed amendments.

A.3 Proposed Amendments Will Tax More than one Party to the Restrictive Covenant

(s. 56.4(2))

The proposed rule will tax the person providing the covenant, even where the amounts paid in respect of the covenant are received by another person. Where a vendor is a member of a corporate group, a covenant not to compete may not relate to a particular individual or group of individuals. Rather, the vendor may be covenanting that the corporate group of which it is a member will not compete with the purchaser. The actual vendor clearly will be one party to the covenant, but its scope may extend to all present and future members of the group, and presumably if even one member of the group were excluded the covenant would be largely meaningless.

The determination of which of these entities would be taxed under proposed subsection 56.4(2), and to what extent, seems far from clear. In appropriate circumstances, provisions such as subsection 56(2) of the Act could be invoked to tax the "true" recipient. In connection with this it is noted that, if an amount in respect of a restrictive covenant were included in the recipient's income under section 9, it could also be included in another taxpayer's income under proposed subsection 56.4(2). The proposed amendments do not appear to limit double taxation in these circumstances.

In addition, where a taxpayer has an income inclusion in respect of an amount received (or deemed to have been received) by a non-arm's length taxpayer, in many cases there will be further tax costs associated with transferring the cash amount actually received in the transaction from the recipient to the person charged with the tax (such as on a dividend from a corporation to its shareholder), which is a form of double taxation.

Recommendation:

We recommend that the proposed amendment be revised so as to clarify that an amount received in respect of a restrictive covenant is to be included in the income of the recipient(s) of the payment and not in the income of the person providing the covenant under S.56.4(2) or under any other section.

A.4 Asset Sales Penalized Under the Proposed Amendments
(s. 56.4(2))

The proposed amendments appear to penalize sale transactions undertaken as asset sales. Where a vendor in a share transaction receives a non-competition payment, the proposed rules provide scope for all or some of the payment to be taxed as a capital gain. Where, however, the same person (i.e., the shareholder) receives a non-competition payment in connection with a sale of assets by his corporation, the amount is to be treated as ordinary income. Clearly, in cases where the recipient of the payment is also the sole shareholder of the vendor this will be seen as a disadvantageous result.

Were the amount received by and taxable to the vendor corporation in connection with the asset sale, presumably it would be included as an eligible capital receipt and taxed on a favourable basis. The tax cost associated with distributing the payment to the shareholder as a combination of ordinary and capital dividend amounts would result in an overall tax cost significantly less than taxes applicable on full inclusion of the amount as ordinary income by the shareholder.

Recommendation:

We are unaware of any policy reason for favouring share sales over asset sales in this fashion, and suggest that consideration be given to allowing recognition of this situation in a manner similar to the rules in proposed paragraph 56.4(3)(c).

A.5 Exceptions to the Income Inclusion Rule
(s. 56.4(3))

Proposed subsection 56.4(3) describes the circumstances in which proposed subsection 56.4(2) will not apply to include in income amounts received or receivable in respect of a restrictive covenant. In our view, the proper operation of these proposals requires a number of changes to this provision.

While proposed paragraph 56.4(3)(a) excludes from the application of proposed subsection 56.4(2) amounts that are included in income under sections 5 or 6 of the Act, there is no similar provision excluding from the application of the proposed amendments amounts already included in income, under section 9 of the Act or otherwise.

As noted, proposed subsection 56.4(2) includes amounts in a taxpayer's income whether received by the taxpayer or another person. However, the relief provided by proposed subsection 56.4(3) is only available in respect of "an amount received or receivable by a taxpayer in a taxation year in respect of a restrictive covenant granted by the taxpayer…" Thus, if the taxpayer has an inclusion under proposed subsection 56.4(2) in respect of an amount received by a non-arm's length party, it appears that no relief is available under proposed subsection 56.4(3).

Proposed paragraph 56.4(3)(c) provides for capital gain treatment for amounts that relate to the disposition of an "eligible interest". "Eligible interest" is defined in proposed subsection 56.4(1) as a partnership interest or share of capital stock, in each case provided the entity "carries on a business". The requirement that the entity carry on business could create potential problems for many taxpayers. For example, this requirement would result in capital gains treatment not being allowed in connection with the sale of shares or a partnership interest where the business in question is carried on by a subsidiary of the corporation or partnership. Proposed paragraph 56.4(3)(c) requires that the amount in question "directly relate" to the disposition of the shares or partnership interest. This should be a sufficient requirement as the taxpayer will need to establish that the payment relates to the sale of shares or a partnership interest.

In connection with proposed paragraphs 56.4(3)(b) and (c) a taxpayer could face an income inclusion that relates to an amount received by another person, which, if received by the taxpayer, would qualify for the application of these provisions. It is not clear why, in those circumstances, capital gains or eligible capital receipt treatment should not be available.

Recommendation:

We recommend that subsection 56.4(3) be modified to address the above concerns.

A.6 Joint Election Requirement
(s. 56.4(3)(b) and s. 56.4(3)(c))

The requirement for a joint election in respect of paragraphs 56.4(3)(b) and (c) raises a number of concerns. The election requirements are applicable to payments received after the Press Release Date. However, as the Backgrounder clearly indicated that amounts described in proposed paragraph 56.4(3)(c) would be treated as proceeds of disposition, which implied that the amounts described in proposed paragraph 56.4(3)(b) would be treated as eligible capital receipts. There was no mention of a joint election being required for capital treatment. Taxpayers who have completed transactions involving restrictive covenant payments of this nature after the Press Release Date will have relied on this treatment, and may not have any ability to require purchasers to enter into elections with them with respect to the now completed sales. Thus, the taxation consequences to such taxpayers could be materially different than those represented in the Press Release and Backgrounder. Clearly, even if the joint election is to be preserved, as a matter of fairness it should not be required for transactions completed during this interim period.

It is not clear why an election is required in connection with either of these provisions. Where paragraph 56.4(3)(b) applies, the payment in question would be subject to taxation under current law and could simply be excluded from the application of these rules. Presumably in most cases, the amount in question will receive symmetrical treatment under the Act, but in those cases where it may not paragraph 56.4(4)(b) could apply to cause symmetrical treatment.

It is not clear why the treatment described in 56.4(3)(c) should not apply in all circumstances to the receipts described therein, which would be consistent with CRA's past administrative practice. At a minimum, it would be consistent with good tax policy for the capital gains treatment provided for in proposed paragraph 56.4(3)(c) to be the default treatment rather than an elective treatment.

The requirement that the election be filed by both taxpayers with their tax returns is quite unusual, exposes vendors to compliance risk beyond their control and, practically, seems to add little benefit to the monitoring of the application of this section. In circumstances where one of the parties is not obliged to file a Canadian tax return for the year in question, it appears that it would be impossible to comply with these requirements. If an election is to be required, some other filing mechanism would be more appropriate to ensure the fair application of these provisions.

It is not clear how an election under proposed paragraphs 56.4(3)(b) or (c) could be made in the context of a reassessment of a taxpayer pursuant to the proposed amendments to section 68 on the basis that amounts reported as proceeds of disposition of shares or other assets were received in respect of a restrictive covenant.

While this problem will not arise if, as recommended, the proposed amendments to section 68 are not made, other, similar issues could arise on a reassessment that would give rise to problems of this nature.

It would also appear to be necessary to include in the definition of "proceeds of disposition" in section 54 amounts referred to in proposed sub-paragraph 56.4(3)(c)(iv).

Recommendation:

We recommend that the joint election requirements and other matters referred to above in proposed paragraph's 56.4(3)(b) and (c) be modified to reflect the above concerns.

A.7 Reference to "Amount" in Proposed Amendments
(s. 56.4(3), s. 56.4(4))

The wording used in each of proposed subsection 56.4(3) and (4) refers to an "amount" but not to a portion of an amount. This may suggests that, for example, if the amount of the payment received by a shareholder for a restrictive covenant in connection with the sale of shares exceeds the amount determined under the A – B formula in proposed paragraph 56.4(3)(c), no part of the payment will be eligible for the beneficial treatment provided under that subsection. Based on the examples, this clearly is not the intended result.

Recommendation:

We suggest that the wording of these proposed subsections be modified to clarify that proposed subsection 56.4(3) may apply to a part of an amount, and that proposed subsection 56.4(4) will apply to that same part. (Corresponding changes to proposed subsection 56.4(2) might be warranted as well.)

A.8 Amounts Received for a Restrictive Covenant May be Deemed Proceeds of Disposition of Property

(s. 68)

The proposed amendments to section 68 of the Act raise a number of very significant concerns. As the Press Release and Backgrounder recognized, it is a commonplace for non-competition covenants to be provided in connection with sales of businesses or companies without separate consideration being paid for those covenants. Even in cases where the practical significance of the covenant is expected to be minimal, the purchaser often will view obtaining the covenant as a good business practice in completing the transaction. The valuation of a non-competition covenant typically will be a fiction as there will have been no prospect of a negotiation of the sale price for the business without such a covenant. In addition, the proposed amendments to section 68 would create a great deal of uncertainty in connection with standard purchase and sale transactions, would potentially disadvantage Canadian purchasers in international transactions and are not required in order to address the *Manrell* decision.

The potential for proposed section 68 to deem proceeds for a restrictive covenant where no such proceeds exist creates a myriad of difficulties, in circumstances where the treatment of the transaction agreed by the parties is consistent with long-standing practice and will result in the amount in question being included in proceeds of disposition for purposes of the Act. Practically, in cases where there is a single vendor and a variety of potential non-arm's length covenanters, any allocation under this section as between share proceeds and restrictive covenant proceeds and as between the vendor and various non-arm's length parties must be entirely speculative, making accurate tax reporting impossible.

Although not clear, it appears likely that this section will apply for purposes of proposed paragraph 212(1)(i). If so, in cases involving non-residents it will be practically impossible to comply with proposed paragraph 212(1)(i) as the amount of any deemed payment will be purely speculative. The rule may lead to withholding tax obligations where both the vendor and purchaser are Canadian residents merely because there are non-resident persons forming part of the vendor group who might be deemed to have received an amount in respect of a covenant. There is no practical way for parties to such a transaction to allocate this risk, and certainly a vendor will not accept additional risk in this regard where a sale to a foreign purchaser would not have this risk. (For example, in a sale of a US based company a Canadian purchaser will be disadvantaged relative to other purchasers as a result of the tax risk associated with this provision.)

Recommendation:

For the reasons set out above, we recommend that the proposed amendments to section 68 of the Act not be pursued, and that proposed section 56.4 apply to payments specified as being for matters that fall within the "restrictive covenant" definition. We recommend that proposed section 56.4 should apply only to amounts that the parties agree are payments for restrictive covenants.

This would achieve the purpose of reversing the *Manrell* decision, would be consistent with long-standing standard practice in Canada and would avoid creating significant uncertainty as to the application of the Act to simple purchase and sale transactions where there historically has been no such uncertainty.

A.9 Amounts Received or Receivable as Deemed Proceeds of Disposition Requires Clarification

(s. 68)

The proposed amendments to section 68 also raise a number of interpretive questions. The section refers to amounts "received or receivable from a person" without indicating by whom they are received or receivable. It refers to a restrictive covenant agreed to by "a taxpayer", amounts received by "the taxpayer" and amounts that are deemed to be paid by "the person to whom the restrictive covenant was granted." Does the unnamed recipient of the amount need to be the "taxpayer" who grants the covenant? Is the "taxpayer" referred to in the opening words the same "taxpayer" referred to in proposed paragraph 68(c)? (Presumably yes.) Is the character of the payment made (as well as of the receipt) reclassified as a payment for a restrictive covenant? Why is the payment deemed made by the beneficiary of the covenant rather than the person paying the amount? How will withholding tax matters be resolved where those two are not the same person?

Recommendation:

We recommend that the proposed amendments to section 68 be clarified so as to address the concerns outlined above.

A.10 Source Deduction Obligations in Respect of Restrictive Covenant Payments *(s. 6(3.1))*

Proposed subsection 6(3.1) provides that in certain circumstances an employee will be required to include in income from employment an amount that is receivable at the end of a taxation year in respect of a restrictive covenant.

It is not clear how the provisions of proposed subsection 6(3.1) will interact with the source deduction obligations of the payor. Subsection 153(1) imposes a withholding obligation on a person paying salary, wages or other remuneration.

Proposed subsection 6(3.1) deems an amount to be received, but understandably does not deem any person to have paid it at the time of receipt. Where the recipient has an ongoing employment relationship with the payor, is this amount to be taken into account in determining source deductions from other wages and salary? In the much more likely circumstance where the recipient has no ongoing relationship with the payor there will be no payment from which to make source deductions.

Will the payor be required to make source deductions when the amount that has been included in income pursuant to proposed subsection 6(3.1) is actually paid in a future period? Clearly, the answer should be that no deductions are required at the later time, but this is not clear given the definition of "salary or wages" in subsection 248(1) of the Act.

Recommendation:

We recommend that the proposed subsection 6(3.1) be amended to clarify the source deduction obligations of the payor.

A.11 Availability of Proposed Deduction for Bad Debt Should be Extended *(s. 60(f))*

Proposed paragraph 60(f) will provide a deduction for a bad debt owing to a taxpayer in respect of amounts included in computing the taxpayer's income under proposed subsection 56.4(2) or 6(3.1). As currently proposed, subsection 56.4(2) may include an amount in the income of someone other than the recipient of the payment.

Recommendation:

If the rules remain unchanged such that a person can be taxable on amounts received by another taxpayer (which is contrary to our recommendation in A.3 above), we recommend that proposed paragraph 60(f) be amended to provide that the person suffering the income inclusion should be entitled to the bad debt deduction in all circumstances in which proposed subsection 56.4(2) may have applied. We note that the corresponding amendment may be required in proposed paragraph 56(1)(m) dealing with inclusions of amounts recovered on bad debts.

A.12 Amounts Subject to Withholding Tax

(s. 212(1)(i))

While there is a recent CRA interpretation to the effect that payments for non-competition covenants are subject to withholding obligations under paragraph 212(1)(d) of the Act, given the *Manrell* decision (CRA Doc. No. 2003-0044351E5) this interpretation could be successfully challenged.

Currently, where a non-resident who is a recipient of payments from a resident of Canada is resident in a treaty jurisdiction, it is necessary to determine whether the payment is subject to withholding tax. The definition of "royalties" in some of Canada's tax treaties may exclude payments that could otherwise be subject to taxation under paragraph 212(1)(d). In addition, amounts arising in the course of a business carried on by the non-resident may constitute business profits and thereby not be subject to tax under the treaty.

Accordingly, it should be clarified that even though payments on account of restrictive covenants are taxed under subdivision d of the Act that the amounts are "business profits" for purposes of Canada's tax treaties, in order that the existing withholding tax regime will continue to apply to such payments. This clarification will not affect circumstances such as in *Manrell*, where the amounts do not constitute business profits.

Given (i) that it is not widely accepted that payments for restrictive covenants are subject to withholding under current law, (ii) that, even if they are, the basis for withholding and therefore the application of the Act and relevant treaties has been changed, and (iii) that no reference to any of this was made in the Press Release or the Backgrounder, introducing this provision with effect from the Press Release Date may result in retroactive taxation. If CRA is correct that paragraph 212(1)(d) of the Act currently applies to non-compete payments, it will be entitled to tax such payments under that provision. If CRA is incorrect, the payments will not currently be subject to withholding tax. Thus, the introduction of proposed paragraph 212(1)(i) with effect from the Press Release Date is either unnecessary or retroactive taxation. We are not aware of any pressing need that justifies this in the circumstances and given that the proposal represents a material change in the Act it should only take effect from the Announcement Date.

As noted in A.9 above, the possible application of proposed section 68 in the context of withholding tax would create difficulties.

Proposed subsection 212(1)(i) may apply in respect of amounts payable by a Canadian taxpayer that relate to foreign business activities, and to competition in non-Canadian markets. It is not clear that this is intended, and it may have significant adverse consequences for Canadian taxpayers in international dealings.

Proposed amendments to subsection 212(13) of the Act may cause difficulties where a contract does not differentiate between payments in respect of Canada and payments in respect of other regions, which existing contracts may do as there would not have been a need to consider such a rule such at the time the contract was entered into. The broad definition of "restrictive covenant" could result in this provision applying to situations other than the situation in *Manrell* if its application is not limited to amounts not otherwise taxable under the Act that are agreed to be payments for restrictive covenants.

Recommendation:

Proposed paragraph 212(1)(i) represents a significant change in the taxation of cross border payments and this was not announced in the Press Release or the Backgrounder. It is recommend that the matters referred to above be fully considered. If this paragraph is to be introduced, it should not take effect prior to the Announcement Date.

B. Trusts and Deferred Income Plans

B.1 Amendment to Definition of Testamentary Trust
(s. 108(1))

Proposed amendments to the definition of "testamentary trust" in subsection 108(1) will exclude a trust that incurs a debt or any other obligation to pay an amount to a beneficiary or a non-arm's length person (referred to as a "specified party"). Certain debts and obligations are disregarded for this purpose — in particular, an amount owed by a trust because of a payment made by a specified party on behalf of the trust. However, it must be reasonable to conclude that the specified party would have been willing to make the payment if the specified party dealt at arm's length with the trust and, in exchange for the payment, the trust must transfer a property to the specified party within 12 months after the payment was made (with provision for the Minister to allow a longer period).

We are concerned that, in many cases, it will be unclear whether the arm's length test is met, or it will clearly not be met. For example, where a beneficiary or executor pays funeral expenses personally, the amount to be paid by the estate will not include interest, nor will it be secured. It is unlikely that an arm's length person would be willing to pay the funeral expenses on these terms.

We note that the payment requirement does not require that the full amount be repaid within 12 months. The payment of $1 by the estate within the 12-month period would appear to satisfy the requirement.

The loss of testamentary trust status causes an estate to lose the ability to utilize the lower marginal tax rates. However, the loss of testamentary trust status could seriously impact an estate in at least one other way. A "tainted" testamentary trust would not be eligible to have a non-calendar year-end under paragraph 104(23)(a). This could preclude the estate from realizing capital losses and carrying them back to the deceased's last taxation year pursuant to subsection 164(6).

For example, assume an individual dies on December 15, 2004. Funeral expenses are paid by the individual's child on December 18, 2004 in a manner that does not satisfy clause (d)(iii)(C). The estate's first taxation year would end on December 31, 2004 which would make it very unlikely that the estate would have had time to realize any capital losses that it may have wanted to carry back to the individual's final personal tax return. Assuming that the child is reimbursed by the estate for the funeral expenses, it is submitted that it is not appropriate for the estate to lose its entitlement to utilize subsection 164(6) simply because the child advanced the funds to pay funeral or other similar costs. It should be noted that in some cases, these types of expenses must be paid by beneficiaries (or some other person) because the executors may not have had time to obtain probate in order to pay the expenses.

Recommendation:

We recommend that the arm's-length test be eliminated, since it is inappropriate for the sorts of situations where payments will be made on behalf of an estate. If the Department of Finance is concerned that this may create opportunities to contribute money to a testamentary trust, the payment requirement could be tightened up to require that the full amount be repaid within the allowable period.

There will occasionally be situations where a trust is not able to repay an amount within 12 months. We recommend that the period be 12 months or, where longer, the shortest period of time within which the trust could reasonably be expected to repay the amount (with provision for Ministerial extension of the period, as in proposed clause (d)(iii)(B) of the definition.)

In the alternative, to address the concerns raised above with respect to funeral and similar costs, we recommend that clause (d)(iii)(C) be amended to read, "except in the case of the first taxation year of an estate, it is reasonable…". Linking the exception of clause (d)(iii)(C) to the first taxation year of the estate is also consistent with the "executors' year" concept which appears to be contemplated in other provisions of the Act such as subsections 164(6) and 164(6.1) and subparagraph 112(3.2)(a)(iii).

B.2 Specified Beneficiary for RRIF-Like Payments from a Registered Pension Plan *(Reg. 8506(7))*

In order for RRIF-like payments to continue to the surviving spouse or common-law partner of a member of an RPP, proposed paragraph 8506(7)(c) of the Regulations requires that the member designate the individual as "the specified beneficiary of the member". Moreover, the designation must be made for specific years. This appears to require that the term "specified beneficiary" be used in a designation, and that the designation specifically state that it is for particular years.

We are concerned that if these formalities are not followed, a designation may be ineffective for purposes of subsection 8506(7) even though it is clear from the designation what is intended. Furthermore, we note that while the term "specified beneficiary" is defined by reference to particular years, it is used in proposed paragraph 8506(1)(e.1) without reference to any year.

Recommendation:

We recommend that subsection 8506(7) of the Regulations be revised so that it applies based on the substance of the designation made by a plan member, not the form of the designation. A beneficiary would be a "specified beneficiary" if the beneficiary is a spouse or common-law partner of the member and the member has directed that periodic payments are to be made to the beneficiary after the member's death.

It appears that the only reason for requiring a designation of the years for which a beneficiary is a specified beneficiary is that this determines whether, in computing the minimum amount for the year after the death of the member, the age of the member or the beneficiary is to be used. An alternative approach would be to use the member's age unless the member has specified that the beneficiary's age is to be used for this purpose (or vice versa).

C. Corporate Reorganizations

C.1 Capital Gains Deferral
(s. 44.1(6) and 44.1(7))

Subsections 44.1(6) and (7), which contain continuity rules for purposes of the capital gains deferral for small business corporation shares, are being amended to include shares that are received in an exchange of shares to which section 51 or 86 or subsection 85.1(1) applies.

The 2004 Proposals reflect the changes to the preambles in subsections 44.1(6) and (7) which we recommended in our May 6, 2003 submission. The preambles now contemplate a taxpayer having a disposition to which section 51 applies. However, paragraph 51(1)(c) provides that a section 51 exchange is not a disposition except for the purpose of subsection 20(21) (a pending amendment would add a reference to proposed paragraph 94(2)(m)).

Recommendation:

We recommend that, in order for a disposition under subsection 44.1(6) and (7) to include an exchange under section 51, paragraph 51(1)(c) be amended to include a reference to subsections 44.1(6) and (7), to provide that the disposition will be a "qualified disposition" for purposes of section 44.1 and that the proceeds of disposition for purposes of subsections 44.1(6) and (7) be equal to the adjusted cost base of the convertible property.

C.2 Deemed Dividends Arising as a Result of "Extraordinary Transactions" *(s. 84(4.1))*

Subsection 84(4.1) treats a payment on a reduction of paid-up capital by a public corporation as a dividend, subject to certain exceptions. The proposed amendments to subsection 84(4.1) introduce a new exception that will apply where the amount paid on a reduction of paid-up capital may reasonably be considered to be a distribution of proceeds realized from a transaction that did not occur in the ordinary course of the corporation's business, and those proceeds were derived from a transaction or event that occurred no more than 24 months before the return of the paid-up capital.

The exact scope of the revisions to subsection 84(4.1) is not clear. Specifically, the reference to "proceeds" suggests that only cash distributions will be able to benefit from this exemption and not in-kind distributions.

In addition, the reference to "proceeds" suggests that this exemption should only apply where there has been a disposition of property, i.e., giving rise to "proceeds".

We suggest that there is no obvious reason why the presence or absence of a "disposition" should cause a public company distribution to be or not be deemed to be a dividend. Instead, the focus of the provision should be on whether what is being distributed relates to an event occurring outside of the ordinary course of business.

For example, the public corporation ("Pubco") may own all of the shares of a subsidiary ("Subco") that acquires the business or shares of a competitor, such that Pubco desires to spin out the newly enlarged Subco to its shareholders as a new public corporation. Such a transaction is clearly outside the ordinary course of business, but may not involve a "disposition" or give rise to any "proceeds" to be distributed. There is no tax policy reason why a distribution of Subco's shares should be deemed by subsection 84(4.1) to be a dividend.

While there will always be unforeseen circumstances that the drafting cannot anticipate, making clear that the tax policy of the provision is to exempt distributions occurring as a result of transactions occurring outside the ordinary course of business would allow the CRA to administer this provision (and in particular deal with ruling applications that most public corporations would submit prior to relying on this provision) in a manner consistent with its intent.

Furthermore, as presently worded, if a relatively minimal amount of property that does not (for whatever reason) meet the test in the new exemption is included in the distribution, the entire distribution is tainted.

Recommendation:

We suggest an "all or substantially all" standard of linkage between the distributed proceeds or property and the non-ordinary-course transaction. An alternative would be to use a "to the extent" standard

We recommend amending the wording of the new exemption to read as follows:

"(a) all or substantially all of the amount may reasonably be considered to arise from or to reasonably relate to a transaction that occurred outside the ordinary course of the business of the public corporation, or of a person or partnership in which the public corporation had a direct or indirect interest at the time that the proceeds or property arose, and within the period that commenced 24 months before the payment; and

(b) no amount that may reasonably be considered to be (or be derived from) those proceeds or that property was paid by the public corporation on a previous reduction of the paid-up capital in respect of any class of shares of its capital stock."

C.3 Definition of "Disposition"

(s. 248(1))

The definition of "disposition" in subsection 248(1) is being amended to add new paragraph (n) which deems no disposition to arise with respect to certain cancelled shares on an amalgamation under subsection 87(1) or a foreign merger under subsection 87(8.1).

New paragraph (n) should apply to shares cancelled on other mergers and amalgamations as well. For example, assume a Canadian corporation ("Canco") owns all of the outstanding shares of a US subsidiary ("Mergersub"). Canco plans to acquire all of the shares of a US corporation ("Target") through a merger in which Mergersub will merge into Target and the former Target shareholders will be issued shares of Canco.

For valid business reasons, Mergersub may acquire some shares of Target prior to the merger (for example, if the trading price of Target is less than would be paid on the merger). Unfortunately, the merger would not qualify as a "foreign merger", as shares of Canco are issued as consideration. Accordingly, Mergersub may be deemed to dispose of its shares of Target on the merger for fair market value consideration, even though there is no economic gain or loss to Mergersub and Canco in respect of such shares.

Recommendation:

We recommend that proposed clause (n)(ii)(C) of the definition of "disposition" in subsection 248(1) be revised to the following:

"(C) a foreign merger (within the meaning that would be assigned by subsection 87(8.1) <u>if subparagraph 87(8.1)(c)(ii) were read without reference to "that was resident in a country other than Canada")</u>, and"

A corresponding change would be required to be made to proposed clause (iii)(B).

C.4 Acquisition of Control of a Corporation

(s. 256(7)(a)(iii))

New subparagraph 256(7)(a)(iii) provides that, where there is an acquisition of any shares of a corporation, there is no acquisition of control of the corporation by a related group of persons if each member of each group of persons that controls the corporation was related to the corporation immediately before the change of control.

It does not, however, extend to corporations controlled by the particular corporation, control of which would otherwise occur. Other provisions such as subparagraph 256(7)(a)(ii) are drafted to ensure that there is no acquisition of control in similar circumstances of corporations controlled by the particular corporation.

Recommendation:

We recommend that clause 256(7)(a)(iii) be amended as follows:

"(iii) The acquisition at any time of shares of the particular corporation <u>or of a corporation controlling the particular corporation</u> if

(A) the acquisition of these shares would otherwise result in the acquisition of control of the particular corporation at that time by a related group of persons, and

(B) each member of each group of persons that controls the particular corporation at that time was related (otherwise than because of a right referred to in paragraph 251(5)(b)) to the particular corporation immediately before that time;"

D. Foreign Property

D.1 Definition of "Foreign Property"
(s. 206(1))

The 2004 Proposals exclude from the definition of "foreign property" in subsection 206(1), indebtedness secured by real property situated in Canada. For the exclusion to apply, the cost amount to a taxpayer of the particular indebtedness "(together with the cost amount to a taxpayer of any other indebtedness in respect of the property that ranks equally with or superior to the particular indebtedness)" must not exceed certain amounts.

The difficulty that arises is that a taxpayer who holds the particular indebtedness has no way of determining the cost amount to another taxpayer of any other indebtedness secured by the property.

Recommendation:

We recommend that the reference to "the cost amount to a taxpayer of any other indebtedness" be changed to "the <u>principal</u> amount of any other indebtedness". A similar change should be made to paragraph 4900(i)(j) of the Regulations as set out in Appendix A of the 2004 Proposals.

E. Charitable and Political Giving

The 2004 Proposals propose numerous amendments to the rules applicable to charitable and political giving that reflect a number of previously announced proposed amendments. The amendments include:

- reintroduction of the proposals originally included in the December 20, 2002 Draft Technical Amendments (the "2002 Proposals") to overcome the common law requirement that for a gift to exist there must be no consideration given to the donor,
- a limitation on the amount of a donation of property to its cost to the donor if the donation is part of a gifting arrangement or donated within three years of its acquisition by the donor, and
- a limitation on the amount of donations where there is limited recourse debt.

The Committee made a number of detailed recommendations with respect to the charitable and political giving provisions of the 2002 Proposals. The recommendations were generally not recognized or reflected in the 2004 Proposals.

In addition, the Committee makes the following observations and recommendations:

E.1 Determination of the "Amount of Advantage" of Gifts for the Purposes of Split Receipting
(s. 248(31)(a)(iii))

The definition of "amount of advantage" includes in (iii) anything "that is in any …way related" to the gift. This is very broad language. Proposed subsection 248(30), which will apply to reduce charitable gifts by the amount of the advantage, applies to gifts after December 20, 2002. However, in respect of a gift after that date, a subparagraph 248(31)(a)(iii) amount could have been received or enjoyed before that date. This would clearly be retrospective. Such an amount should continue to be governed by the law applicable before December 20, 2002.

Recommendation:

We recommend that the relevant coming into force provision should provide that it is only subparagraph 248(31)(a)(iii) amounts received or enjoyed after December 20, 2002 that are to be deducted.

E.2 Split Receipting
(s. 248(30) and s. 248(31))

The eligible amount of a gift is to be reduced by the amount of an advantage. The definitions do not require that the advantage has to have been received from the donee.

Recommendation:

We recommend that a corresponding amendment is needed to clarify that the donee is not required to reduce the receipted amount of a gift by any advantage not received from the donee and of which it is unaware.

E.3 Deemed Fair Market Value
(s. 248(35))

The deemed fair market value rule in subsection 248(35) applies where property that is the subject of a gift was acquired under a gifting arrangement, or was acquired within 3 years of the gift or with an expectation of making the gift. The existence of any of these circumstances may not be known by a donee.

Recommendation:

We recommend that a corresponding amendment is needed to clarify that the donee is not required to reduce the receipted amount of a gift by the application of this provision.

F. Credit Unions

F.1 Credit Unions Deemed CCPCs to Benefit From Specified Deductions
(s. 137(7) and s. 123.4))

Subsection 137(7) deems a credit union that is a private corporation not to be a private corporation, except for specified provisions. The amendment to subsection 137(7) includes section 123.4 in the list of specified provisions, commencing with the 2001 taxation year. The purpose of this proposal is to allow the special rate reduction for Canadian-controlled private corporations ("CCPCs") to apply to credit unions that, but for subsection 137(7), qualify as CCPCs.

However, as a credit union is not a private corporation for all purposes, In particular, a credit union is not a private corporation for purposes of section 129 of the Act. Under subparagraph (b)(iii) of the "full rate taxable income" definition in section 123.4, CCPCs are required to reduce the income eligible for the reduction by its aggregate investment income for the year, within the meaning assigned by subsection 129(4). Ordinarily, this will be appropriate, since this amount is eligible for refundable treatment.

However, when applied to a credit union, this result is inappropriate since the credit unions do not get refundable treatment on capital gains, because a credit union is not a private company for the purposes of section 129. If a credit union's capital gain did reduce "full rate income" for purposes of the CCPC tax reduction, the taxpayer could be in a worse position than before the proposed amendment to subsection 137(7) since it appears than the credit union will not qualify for any general tax reduction on the gain.

Recommendation:

We recommend that subparagraph (b)(iii) of the definition of "full rate taxable income" in section 123.4 be amended to ensure that the subparagraph will not apply to a credit union. That is, subparagraph (b)(iii) of the definition of "full rate income" should provide:

"except where the corporation is a credit union,…"