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July 29, 2005

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

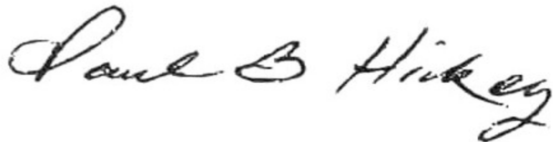
Dear Mr. Ernewein:

Re: Issues for Consideration — Next Technical Amendments Bill — 2005 Submission

We are pleased to submit the attached brief ("2005 submission") for your consideration and review. Our 2005 submission highlights a wide variety of technical issues raised by members of the tax community that we hope you will be able to consider for the next technical amendments bill. These issues do not include the matters raised in our March 15, 2002 submission ("2002 submission"), which are still outstanding.

We trust you will find our comments and recommendations helpful and we would be pleased to meet with you to discuss any of the issues raised in our 2002 and 2005 submissions.

Yours truly,



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Cc: Mr. Len Farber, Dept. of Finance

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2005 JOINT COMMITTEE TECHNICAL SUBMISSIONS

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A. Personal Taxation

A.1 Tax on Old Age Security Benefits

(Subsection 180.2)

Social benefits repayments are calculated according to a formula based on net income, under section 180.2. Capital losses incurred in a year will offset capital gains arising in the same year, thereby reducing the taxpayer's net income and, consequently, social benefits repayments for the year. If the capital losses for a year exceed the capital gain for that year, the excess losses can be carried forward or backward to years when there are capital gains. However, because those excess capital losses are deductible as net capital losses of other years, and are not applied against net income, the social benefits repayments of those years remain at the previously calculated amounts and do not reflect any relief for the capital losses carried backward or forward.

As a result of this inequity, different taxpayers who have the same aggregate taxable incomes over several years may have different net incomes for the calculation of social benefits repayments and, as a result, may incur substantially different social benefits repayments.

Recommendation:

We recommend that the computation of social benefits repayments should be reduced for net capital losses carried back or forward to other years.

A.2 RRSP/RRIF Losses From Time of Death to Time of Estate Distribution

(Section 146)

Although the CRA has introduced administrative rules that provide relief in certain situations for RRSP/RRIF losses that accrue after the death of an individual and before the plan is liquidated, relief is not available when a rollover

of a deferred plan is unavailable (e.g., when an RRSP is passed on by a widowed annuitant to her children).

The Department of Finance has indicated that an administrative solution should be adopted. However, as illustrated by the following comments on the CRA's website (http://www.ccra-adrc.gc.ca/tax/registered/2002rrspinfo-e.html), an administrative fix to this problem may be impossible:

> We have reviewed this problem extensively. During our review, certain issues were brought to light that have not yet been fully clarified. We tried to develop a fair way to deal with the post-death decrease in all situations. Unfortunately, given the variety of situations and complexity of the legislation, we were not able to develop an acceptable solution that could be applied universally.
>
> In light of the above, CCRA will only provide relief in situations where all the funds paid out of or under a deceased annuitant's unmatured RRSP or RRIF, continue to be sheltered (i.e., the funds are transferred under paragraph 60(1) to a qualified beneficiary).

Recommendation:

We recommend that legislation should be implemented to deal with a decline in the value of plan assets held at death, similar to the rules in section 146 that tax appreciation of RRSP/RRIF assets after death. Section 146 taxes an appreciation of RRSP assets after death as income and also provides a means to prorate the income inclusion when only a portion of the RRSP is rolled over to a plan for a spouse or qualified child. Similar rules should apply when a decline in value has occurred. Also, for consistency with other rules for losses after death, the loss should be treated as an income loss, eligible for carryback to the terminal return under subsection 164(6) to offset the income inclusion on death.

A.3 Deferral of Stock Option Benefit

(Subsections. 7(8), 220(4.5) and 128.1(6))

Subsection 7(8) allows for the deferral of certain employee stock option benefits until the year the security is disposed of. If the employee continues to hold the security and becomes a non-resident of Canada, the security is deemed to be disposed of by paragraph 128.1(4)(b) and the option benefit must be included in income in the employee's departure year tax return.

Subsection 220(4.5) allows an individual to defer the tax that arises as a result of the deemed disposition in paragraph 128.1(4)(b), including the tax on the stock option benefit. The tax on the option benefit arises solely because the security is deemed to be disposed of by paragraph 128.1(4)(b). The individual is required to provide security to the Minister to defer the tax under subsection 220(4.5).

Security will no longer be accepted after April 30 following the year Canadian residency is re-established, because at that time the property is deemed to have been disposed of and reacquired. An individual may elect under paragraph 128.1(6)(c) to unwind gains that arose as a result of the deemed disposition under paragraph 128.1(4)(b). The Technical Notes state that, "In broad terms, 128.1(6) provides that an emigrant who returns to Canada at any time after emigration is no longer treated as having realized accrued gains on departure."

The unwinding provision in paragraph 128.1(6)(c) only applies to an individual's gains from the deemed disposition of property owned in the year of departure. This provision does not apply to the stock option benefit, which is employment income and not a gain. Therefore, an individual who has re-established Canadian residency is not able to further defer the tax on the stock option benefit. We are not aware of a policy concern that should result in the loss of deferral on the stock option benefit when an individual re-establishes Canadian residency. From a policy perspective, it would be consistent with the intent of the stock option

deferral rules to allow the deferral when an individual re-establishes residency. Such a treatment would also be consistent with the treatment of accrued gains.

Recommendation:

We recommend subsection 128.1(6) be amended to allow for the unwinding of the subsection 7(8) stock option benefit inclusion similar to the unwinding of gains in paragraph 128.1(6)(c). Such an unwinding could be accomplished if the individual elects not to have the deemed disposition in paragraph 128.1(4)(b) apply in the emigration year for purposes of subsection 7(8) where the security is still held at the time of immigration. The individual would then be required to continue to report the deferred benefit on Form T1212 until the security is actually disposed of, and the benefit is included in income.

A.4 Attributed Income and Foreign Tax Credits
(Subsections 56(4.1), 74.1, 74.2 and 75(2))

Under subsection 75(2), income can be attributed to a person (referred to as “settlor”) who has transferred property to a trust. If foreign income is earned by the trust, then that income would be attributed to the settlor. However, there is no provision in the *Income Tax Act* to attribute any foreign taxes paid on the foreign income to the settlor.

There does not appear to be any tax policy reason why attributed income should be treated any differently from other income taxable to a person. The proposed new rules for offshore trusts under subsection 94(1) are not punitive in this manner and provide relief for foreign taxes paid. The rules in subsections 104(22) to 104(22.3) for other domestic trusts, the foreign affiliate and foreign accrual property income system, and the proposed new rules for foreign investment entities also provide such double tax relief. In addition, the income splitting “kiddie tax” under section 120.4 provides foreign tax credit relief (see subparagraph 120.4(3)(b)(i)).

The lack of a provision to attribute any foreign taxes paid causes double tax or partial double tax. If the foreign income is income from property, such as dividend or interest income, deductions can be claimed under subsections 20(11) or 20(12), thereby reducing the double tax effect of the foreign taxes paid. However, in the case of foreign taxes paid on capital gains, no deduction can be claimed under subsection 20(11) or 20(12), resulting in double tax.

A similar issue arises for income attributed under sections 74.1, 74.2, and 56(4.1).

Recommendation:

We recommend introducing rules to provide for double tax relief for attributed income such as income attributed under subsections 75(2), 74.1, 74.2 and 56(4.1). For example, the foreign tax credit legislation in section 126 could be amended to provide a credit to a taxpayer that has attributed income or capital gains for the foreign tax paid on such attributed income. Thus, double tax relief could be provided by deeming the taxpayer to have paid the foreign tax paid on the attributed income.

A.5 Non-Resident Individuals and Foreign Tax Credits
(Paragraph 115(1)(a))

The 2001 technical bill extended subparagraph 115(1)(a)(i) to include in the Canadian taxable income of a non-resident person any income received in the calendar year by that person that had been previously earned outside of Canada while the person was a resident of Canada. However, there is currently no provision in the ITA to enable such a person to claim a foreign tax credit against the Canadian tax imposed under this revised subparagraph for any tax imposed by the person's country of residence or by the country where the income was earned.

We are aware of situations in which this omission has resulted in double taxation in the absence of any treaty relief. Typically, these situations involve taxpayers who carry out a portion of their employment duties outside of Canada while they are residents of Canada and the relevant portion of their compensation for these duties is charged back to sources in those other countries. If, after ceasing Canadian residency, these individuals receive any deferred compensation (typically in the form of a bonus) that was earned in the other country, they will be subject to tax in both that country and in Canada without any recourse to possible relief from double taxation under a tax treaty. Had these individuals remained residents of Canada at the time of the receipt of the non-Canadian deferred employment income, they would have been able to claim a credit for the taxes arising in the other country against their Canadian tax liability on the deferred income under section 126.

Recommendation:

It is proposed that this omission be corrected by either:

- Revising section 126 to add a provision similar to subsection 126(2.2), which applies to allow a foreign tax credit on Canadian departure tax imposed under subsection 128.1(4) for tax on the same income. This provision would enable a non-resident who is subject to Canadian tax under subparagraph 115(1)(a)(i) on income earned outside of Canada to reduce the tax by claiming a credit equal to the lesser of the Canadian tax and the tax imposed on the same income by the country where the individual is a resident when it was received or the tax imposed by the country where the income was effectively earned;
- Revising section 119 to allow a non-resident subject to Canadian tax under subparagraph 115(1)(a)(i) to claim a credit equal to the lesser of the Canadian tax and the tax imposed on the same income by the country where

the individual is a resident when it was received or the tax imposed by the country where the income was effectively earned; or

- Amending subsection 115(2) to add a provision that, notwithstanding subsection 126(1), a non-resident person who is subject to Canadian tax under subparagraph 115(1)(a)(i) on income that was earned outside of Canada will be entitled to claim a foreign tax credit equal to the lesser of the Canadian tax and the tax imposed by the non-resident's own country of residence or, if applicable, by the country where the income was actually earned.

A.6 Ceasing to be Canadian Resident – Home Buyers' Plan and Lifelong Learning Plan

(Section 146.01 and subsection 146.02(5))

Subsection 146.01(5) of the Act applies if an individual who ceases Canadian residence has withdrawn funds from an RRSP under the Home Buyers' Plan (HBP) to acquire a Canadian home. This provision requires the individual to repay the withdrawal (to the extent not previously repaid or included in income) within 60 days of becoming a non-resident and before the taxpayer files a tax return for that year. This will always result in the imposition of the 60-day deadline. If the repayment is not made, the balance is included in the individual's income for the period in which he or she was a resident of Canada.

In many cases, departing individuals will not have sold their Canadian homes within 60 days of becoming non-resident. In other cases, the departing individuals may not want to sell their Canadian homes. These individuals may experience hardship because they will have to arrange financing to repay the HBP withdrawal, which may not be possible before the 60-day deadline.

In addition, departing individuals are often unaware of the 60-day requirement imposed under subsection 146.01(5). Not only will these individuals have to pay

tax that they had not budgeted for, but they will also lose the future tax deferral that they would have realized on the repayment to their RRSPs.

A similar situation arises under subsection 146.02(5) if an individual who ceases Canadian residence has withdrawn funds from an RRSP under the Lifelong Learning Plan (LLP).

Recommendation:

These hardships can be alleviated if the deadline for departing individuals to repay the HPB withdrawal is changed to 60 days after the end of the year of departure. This proposed deadline would coincide with both the normal deadline provided in subsection 146.01(3) for making annual repayments of "eligible amounts" by residents to their RRSPs, as well as with the normal deadline for making RRSP contributions for the previous year. This change would give departing individuals a fairer opportunity to become aware of and plan for the repayment requirement and the consequences for failing to meet this requirement.

Alternatively, an amendment could provide that the RRSP withdrawal could be repaid after the existing 60-day limit. In the year of the repayment, the individual would be permitted to amend his or her tax return that reported the subsection 146.01(5) inclusion by claiming an offsetting deduction for the repayment. A requirement could be added that the repayment must be made within a specified time (e.g., one or two years after ceasing residence).

Another alternative would permit individuals who do not comply with the existing 60-day deadline (e.g., because they are unable to sell their homes or arrange refinancing within the 60-day limit or they are unaware of this limit) to obtain a refund of the resulting tax. This provision would parallel the rules in subsections 15(2), 214(3) and 227(6.1) that apply when a non-resident individual

repays a shareholder loan that was previously subject to Canadian withholding tax under subsection 214(3).

A third alternative is to introduce a provision similar to subsection 126(2.22), which permits trusts to claim foreign tax credits with respect to foreign tax paid by non-resident beneficiaries on the disposal of trust property if the distribution of the property to the beneficiary was already subject to Canadian tax. In this alternative and the previous one, the tax is paid up front and relief is granted later.

A.7 Qualifying Stock Options — Prescribed Shares
(Regulation 6204)

Regulation 6204 prescribes shares for purposes of paragraph 110(1)(d), which provides a deduction for one-half of the taxable benefit on exercise or disposition of a qualifying stock option. There are several technical difficulties with the Regulation.

A share will not be a prescribed share if, among other things:

- the holder of the share can cause the share to be redeemed, acquired or cancelled by the corporation or any specified person in relation to the corporation (with an exception for a cancellation relating to a permitted conversion) (Regulation 6204(1)(a)(iv)); or
- the corporation or a specified person in relation to the corporation can reasonably be expected to redeem, acquire or cancel the share within two years after the share is sold or issued (Regulation 6204(1)(b)). (Note also that Regulation 6204(1)(b) does not contain the same exclusion for conversions contained in Regulation 6204(1)(a)(iv), which is another technical problem with the rules.)

Subsection 6204(3) of the Regulations provides that, for the purposes of subsection (1), "specified person" means a person or partnership with whom the corporation does not deal at arm's length otherwise than because of a right

referred to in paragraph 251(5)(b) of the Act that arises as a result of an offer by the person or partnership to acquire all or substantially all of the shares of the corporation.

It is believed that this provision was added to address the concern that, if a takeover bid had been made, the bidder might, at the time when it is obligated to take up and pay for the target's shares, be deemed not to deal at arm's length with the target corporation and thus to be a specified person in relation to the corporation.

It is common in a takeover situation for unvested options to vest to permit employees holding stock options to tender to the bid and share in the bid proceeds. If their shares are not prescribed shares because the offeror is deemed to be a specified person in relation to the target, then either one of the provisions referred to above could taint the shares.

The difficulty with subsection 6204(3) as drafted is that it applies only in very narrow circumstances. The acquirer of the shares must be deemed not to deal at arm's length by virtue of a right that arises as a result of an *offer* to acquire *all or substantially all* of the shares of the target.

Many acquisition transactions no longer take the form of an "offer", but rather, may be effected under some form of shareholder and/or court-approved transaction. For example, it is common for acquisitions to occur under a plan of arrangement that is approved by the court and by the shareholders. Typically, the acquirer will enter into an agreement with the target providing for the terms on which the arrangement will occur. An agreement referred to as a "lock-up agreement" may be entered into with significant shareholders, under which they agree to support the transaction and vote their shares in favour of the transaction. The target and the acquirer then apply to the court for interim approval of the plan, a shareholders meeting is held at which the plan is approved, and a final

order is then issued by the court. Once the shareholder approval is given, it is possible that the acquirer could be considered to have the right to acquire the target shares, which would make the acquirer a "specified person" (subject to any exception provided for in the Regulation). In the case where a lock-up agreement is entered into with shareholders holding a majority of the shares, the lock-up agreement itself may result in the acquirer becoming a specified person.

The "carve-out" for persons who would be a specified person only by reason of a right that arises as a result of an offer for all or substantially all of the shares of the target is not broad enough to cover alternative forms of transactions, such as acquisitions that occur as a result of implementation of a plan of arrangement. Further, even in the case of an acquisition effected by takeover bid, the requirement that the offer be for all or substantially all of the target's shares is problematic, given the CRA's view that this is a 90% or greater threshold. In cases when the acquirer already holds more than 10% of the target shares it is not clear whether the requirement is met, although common sense would suggest reading in the words "not already held" by the offeror. However, if the offer is for only 51% of the target's shares or 66 2/3%, for example, then the carve-out does not appear to apply.

Recommendation:

We do not think it is intended that employees will not receive the benefit of the paragraph 110(1)(d) deduction in the case of an acquisition effected by some means other than a takeover bid. There are several ways to address the issue. One would be to simply exclude from the definition of a "specified person" persons or partnerships who are only deemed non-arm's length by virtue of a right referred to in paragraph 251(5)(b). Another way to approach the problem would be to broaden the reference to "offer" to include other transactions in which the shares of the target corporation are acquired (or the target is merged with the acquirer) that have substantially the same effect as an offer for the shares. The threshold

should be lowered to no longer require an acquisition of 90% or more; it should be sufficient that a majority of the target's shares be held after completion of the transaction.

B. Business/Property Income

B.1 Deemed Disposition of Property by a Lessee
(Paragraph 16.1(1)(f))

Section 16.1 provides special rules to compute the income of a lessee of certain property. Paragraph 16.1(1)(f) in respect of a deemed disposition of property by a lessee is unclear as to whether an assignment of the lease by the lessor triggers such a deemed disposition by the lessee. We submit that the consequences of paragraph 16.1(1)(f) from an "assignment" should only apply to an "assignment" by the lessee, not an "assignment" by the lessor. Section 16.1 as a whole is consistent with this view, particularly when subsections 16.1(2) and (3) and paragraph 16.1(1)(i) are considered.

Recommendation:

We propose that the preamble of paragraph 16.1(1)(f) be revised (revision in italics) to reflect the following:

"at the time of the expiration or cancellation of the lease *or* the assignment of the lease or the sublease of the property by the lessee …"

B.2 Eligible Capital Property/Capital Dividend Account Calculation Anomaly
(Subsection 89(1) "capital dividend account")

When the capital gains inclusion rate was reduced to 50% in 2000, the rules for eligible capital property were extensively rewritten. As part of the rewrite, it appears that an anomaly has arisen when eligible capital property is sold after

2000 and the corporation acquired the eligible capital property before the corporation's adjustment time as set out in subsection 14(5).

The issue is complicated and is illustrated in CRA technical interpretation #2002-0173535, dated January 21, 2003. In the circumstances described in the interpretation, the amount that should have been added to the capital dividend account under paragraph (c.2) of the definition of capital dividend account in subsection 89(1) should have been $57,500 (50% of $115,000). However, the CRA computed the amount to be added to be $22,400. The interpretation also indicated that the CRA has previously informed the Department of Finance on the application of the definition of capital dividend account in other situations similar to the one described in the interpretation.

Recommendation:

The rules should be adjusted to correct the anomaly.

B.3 Deductibility of Life Insurance Premiums
(Paragraph 20(1)(e.2))

Paragraph 20(1)(e.2) permits a deduction for life insurance premiums on a policy assigned as collateral for a loan when, among other things, the lender is a restricted financial institution (as defined in subsection 248(1)). The post-amble to paragraph 20(1)(e.2) requires that the amount to be deducted must reasonably "relate to the amount owing from time to time during the year by the taxpayer to the institution under the borrowing".

An issue with the deductibility of life insurance premiums under paragraph 20(1)(e.2) arises when the financial institution assigns its rights under the loan agreement to a securitization vehicle. There may no longer be an amount owing by the taxpayer to the original institution under the original borrowing, in

which case the premiums may cease to be deductible under paragraph 20(1)(e.2) following the securitization transaction.

The CRA has provided its views on this issue in technical interpretation #2002-016708, dated January 14, 2003. The CRA's position is that a deduction under paragraph 20(1)(e.2) would not be available if the lender is no longer a financial institution after the securitization transaction. This result is inequitable because the borrower may not be informed of the securitization transaction and has no control over whether the financial institution participates in such a transaction.

Recommendation – We recommend that the words "to the institution" in the post-amble to paragraph 20(1)(e.2) be removed.

C. Trust Taxation

C.1 Qualified Disposition to Trust

(Subsections 107.4(3), 104(5.8), and paragraph 104(4)(a.4))

When there is a "qualified disposition" of a property as defined in subsection 107.4(1), the transferor is allowed to elect under subparagraph 107.4(3)(a)(i) to have proceeds of disposition equal to an amount between the property's cost amount and its fair market value. If the transferor elects for the proceeds to be equal to the fair market value of the property, no portion of any accrued capital gain on the property will be deferred.

Subsection 104(5.8) generally provides that, when there has been a transfer by a trust to another trust, the creation date of the transferee trust is deemed to be the creation date of the transferor trust for the purposes of the "21-year rule" in subsection 104(4). However, according to the preamble to subsection 104(5.8), this subsection only applies when subsections 107(2), 107.4(3) or paragraph (f) of the definition of "disposition" in subsection 248(1) apply. These provisions

generally apply when there has been a "rollover" of property from one trust to another trust. However, if the taxpayer elects under subparagraph 107.4(3)(a)(i) for the proceeds to be equal to the fair market value of the property, a rollover has not occurred. The wording of subparagraph 107.4(3)(a)(i) is such that subsection 107.4(3) applies regardless of the transferor's elected amount.

Recommendation:

We recommend that subsection 104(5.8) not apply when an election has been made under subparagraph 107.4(3)(a)(i) and the elected amount for proceeds of disposition equals the property's fair market value. As such, if no rollover arises on the transfer of property to the transferee trust, then the transfer is essentially the same as any other transfer to a trust when no rollover arises. Accordingly, the application of the 21-year rule to the transferee trust should not be based on the creation date of the transferor trust.

Note that a taxpayer can elect out of the rollover under subsection 107(2) and paragraph (f) of the definition of "disposition" in subsection 248(1). An election under subsection 107(2.001) causes subsection 107(2) to not apply and an election under subparagraph (v) paragraph (f) of the definition of "disposition" causes that paragraph to not apply. In both cases, the elections would also cause subsection 104(5.8) to not apply. Therefore, when a transferor trust elected under subparagraph 107.4(3)(a)(i) for the proceeds to equal fair market value, the result would be consistent with these other provisions.

There is a similar issue relating to paragraph 104(4)(a.4). That paragraph applies when subsections 73(1) or 107.4(3) have applied to a transfer of property to a trust. When subsections 73(1) or 107.4(3) have applied to defer a capital gain, this result is considered to be appropriate. However, if a transferor has elected out of the rollover under the preamble to subsection 73(1) or subparagraph 107.4(3)(a)(i) respectively, then paragraph 104(4)(a.4) should not apply. In the case of a

subsection 73(1) transfer, this is the result under paragraph 104(4)(a.4). If a transferor of property elects out of the rollover in subsection 73(1), then that election causes that subsection not to apply. However, in a transfer under subsection 107.4(3), that subsection still applies even if the taxpayer elects under subparagraph 107.4(3)(a)(i) for the proceeds on the transfer to equal the property's fair market value.

Accordingly, we recommend that subsection 107.4(3) be amended such that, when a transferor elects for the proceeds to be equal to the transferred property's fair market value, that subsection will not apply. This change would result in subsection 104(5.8) and paragraph 104(4)(a.4) not applying to that transfer.

C.2 Donations by a Spousal Trust
(Section 118.1)

It is common for an individual under his or her will to leave assets for his or her surviving spouse in a spousal trust and for all or a portion of those assets to be left to a registered charity after the death of the individual's spouse. Usually the trustees of the spousal trust are provided with some authority to encroach on capital for the benefit of the surviving spouse.

The provisions in section 118.1 are not clear as to whether a donation tax credit can be claimed by the individual or the spousal trust in this situation. The CRA has issued technical interpretations that state that the spousal trust can claim a donation tax credit if the trustees have the authority to encroach on capital for the benefit of the surviving spouse. Although this administrative position probably provides the correct result, it is not clear that it is technically correct.

In addition, practical problems can arise in applying the CRA's administrative position. For example, assume an individual dies leaving a capital property to a trust for his spouse and the requirements for a spousal trust under subsection 70(6) are satisfied. Further, assume that there is a significant accrued gain on the

property and that a significant portion of the spousal trust's assets will be left to a registered charity after the death of the surviving spouse. The trustees have the power to encroach on capital for the benefit of the surviving spouse during her life. The spousal trust's taxation year-end is December 31.

If the spouse dies late in December of a particular year, such as December 30, then the trustees will not have the opportunity to make the donation before the end of the taxation year in which the spouse dies. Considering that the taxation year in which the spouse dies will be in the taxation year in which the accrued gain on the capital property will be recognized, the donation tax credit will not be available to shelter any tax arising on that capital gain. There is also no provision to carry back a donation, assuming the donation was made in the year subsequent to the taxation year in which the spouse died. Accordingly, tax will likely arise in the taxation year in which the spouse dies and the donation will likely be made in the subsequent taxation year, in which there may be little if any income or tax liability. We submit that this mismatching of tax arising on the death of the surviving spouse and the donation tax credit is inappropriate.

Recommendation:

We recommend that the rules in subsection 118.1 be modified to clarify who is entitled to the charitable tax credit in these situations. In addition, a carryback for spousal trusts should be introduced so that the donation tax credit can be claimed against the capital gain arising in the spousal trust on the death of the surviving spouse.

D. Partnerships

D.1 Flow-Through of Resource Pools from One Partnership to Another Partnership

(*Paragraphs 66.4(5)(b) and 66.2(5)(f)***)**

The definitions of "Canadian oil and gas property expense" in subsection 66.4(5)(b), "Canadian development expense" in subsection 66.2(5)(f), "Canadian exploration expense" in subsection 66.1(6)(h) and "foreign exploration and development expenses" in subsection 66(15)(d) all purport to flow such amounts incurred by a partnership through to a "taxpayer" that was a "member" at the partnership's year-end.

However, there is a technical concern that such amounts incurred by a lower tier partnership may not be flowed through a tiered partnership structure on the basis that the higher tiered partnership may not be viewed as a "taxpayer" or "member" of the lower tier partnership.

Recommendation

To resolve this concern, we suggest extending the deeming rules in subsection 66(16) and 100(2) to the foregoing provisions and clarifying that a partnership can be a taxpayer and a member of another partnership for these purposes.

D.2 Negative ACB of Limited Partnerships

(*Subsection 40(3.1), paragraphs 53(1)(e) and 53(2)(c)*)

There is a material and widespread problem affecting limited partners that stems from the deemed gain rule in subsection 40(3.1). The problem arises when a limited partner's ACB is negative "at the end of a fiscal period of a partnership". Income distributions reduce a limited partner's ACB at the *time* of the distribution under subparagraph 53(2)(c)(v) and the corresponding income allocation is not added to a limited partner's ACB until *after* the end of a fiscal year under

subparagraph 53(1)(e)(i). Thus, for the purposes of determining whether a limited partner is deemed to have realized a gain from a negative ACB "at the end of the fiscal period", its distributions are deducted from ACB and no "credit" is given for its allocation of partnership income for the corresponding partnership fiscal period. Further, the ability of a limited partner to trigger a corresponding loss under subsection 40(3.12) to carry back to offset a gain realized under subsection 40(3.1) is restricted by the limitations in subsection 40(3.12), which often circumscribe its utility for limited partnerships that continue to distribute income in the next fiscal period.

Recommendations:

We recommend that either:

- The deemed gain rule in subsection 40(3.1) be amended to apply "immediately after the end of a fiscal period of a partnership" (so as to include the corresponding basis adjustment for income under subparagraph 53(1)(e)(i)), or
- The approach referred to in the July 11, 2003 comfort letter applicable to LLPs be extended to a limited partner of another partnership. The comfort letter recommends that "…for the purposes of …subsection 40(3.1)…the Act be amended to provide that the ACB of a full shield professional LLP be adjusted at the end of the fiscal period of the LLP to reflect income (loss) allocations made by the LLP at that time." We see no policy reason why this approach should not be extended to a limited partner of another partnership.

D.3 Withholding Tax Rate on Dividends Paid to Partnership with U.S. Corporate Member

(*Subsection 212(2) and Canada-U.S. Income Tax Convention*)

Subsection 212(2) imposes a tax on a non-resident person on dividends paid by a Canadian resident to the non-resident person at a flat rate of 25% of the dividends

paid. A partnership, other than a Canadian partnership, that receives a dividend from a Canadian resident is deemed to be a non-resident person (paragraph 212(13.1)(b)).

According to the CRA, Article X of the Canada-U.S. Income Tax Convention may apply to reduce the Part XIII withholding tax rate to 15% on a U.S. resident member's proportionate share of dividends paid to the partnership by a Canadian corporation (CRA Round Table, Canadian Tax Foundation Annual Conference 1991, 91 CR 50:1-2). However, the 5% reduced rate under Article X will not apply even if the partnership owns more than 10% of the voting stock of the company paying the dividends.

Recommendation:

We recommend that the law be amended to provide for a partnership look-through rule so that a corporate partner that has a 10% ownership interest in the voting stock (determined by applying the usual fair market value approach to impute partnership property to partners) will be eligible, when applicable under a treaty, to a reduced 5% withholding tax rate.

E. Farmers

E.1 Eligible Capital Property of a Farmer on Death
(*Subsections 24(2) and 70(5.1)*)

Under existing subsection 70(5.1), a deceased taxpayer is deemed to have disposed of eligible capital property (ECP) in respect of a business immediately before his death for proceeds equal to 4/3 of the proportion of any positive balance in the pool that the fair market value of the property represents of the total fair market value of all the ECP of the taxpayer for the business.
Subsection 70(5.1) does not apply if the ECP is acquired by the deceased taxpayer's spouse or controlled corporation and subsection 24(2) applies.

Subsection 24(2) prevents the individual who has ceased carrying on the business from claiming a terminal allowance. Instead, the pool is reduced to nil.

When a farmer holds ECP on death, such as farm quota, it is not possible to elect on the terminal return of the farmer to create a fair market value disposition that can be offset with the deceased's capital gains exemption in certain situations. However, the farmer can sell the property to a spouse or other person prior to death so that the exemption is claimed. The fact that such steps have to be taken seems unfair when compared with the treatment of other amounts on death.

Recommendation:

We recommend that an executor be allowed to make an election so that ECP of a farmer can be transferred at fair market value on his or her death.

F. Administration

F.1 Reassessments Relating to Dividend Exceeding Capital Dividend Account *(Subsection 184(4))*

CRA technical interpretation #2003-0051211I7, dated January 30, 2004, considers the implications of an election under subsection 184(3) in respect of an excess capital dividend when the taxation year of the payor corporation is statute-barred. The election allows the excess capital dividend to be deemed to be a taxable dividend. The CRA comments that, in this situation, the recipient corporation or individual can be assessed Part IV tax or personal tax in accordance with subparagraph 184(4)(b)(ii) even when the taxation year in which they received the dividend is statute-barred. However, the CRA states that a reassessment of the payor corporation with regard to any dividend refund to which it would otherwise have been entitled cannot be made when the taxation year of the corporation is statute-barred. The CRA explains that the payor is subject to the subsection 152(4) limitations on the normal reassessment period.

The CRA's position means that the payor corporation will not be entitled to a dividend refund for the excess capital dividend. Because the earnings of the payor corporation have been distributed in the dividend payment, the refundable dividend tax on hand of the payor corporation could become "trapped" as the corporation may not have other retained earnings that could be paid as a dividend to recover the refundable tax. Such a result causes the refundable tax to become a permanent tax.

Recommendation:

We recommend that subsection 184(4) be amended to permit a reassessment of the payor corporation when the payor's taxation year is otherwise statute-barred when a subsection 184(3) election is made. Such an amendment would permit the payor corporation to be reassessed for a dividend refund.

G. Miscellaneous

G.1 Definition of "Investment Business" of a Foreign Affiliate
(s. 95(1))

The parenthetical words in paragraph (a) of the definition "investment business" in subsection 95(1) prevent the exceptions from that definition from applying to a foreign affiliate (FA) when the relevant business of the FA is conducted principally with non-arm's length persons. In many cases, Canadian multinationals will use a "central" FA in one jurisdiction to license/lease/(distribute) property to sister FAs located in the target market. The sister FAs will then license/lease/distribute the end-products to third parties in the target market. Sister FAs are used because the home jurisdiction either requires the use of a separate entity (e.g., China) or is simply better served by a separate entity for commercial reasons (e.g., the U.S.). If the central FA has more than five

full-time employees, it should not lose the benefit of the exceptions under these circumstances.

Recommendation:

At a minimum, we propose that the parenthetical words be amended to permit the central FA to avail itself of the exceptions when the sister FAs with which the central FA conducts its business conduct their businesses (without regard to the business conducted with the central FA) principally with arm's length persons.