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

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April 25, 2006

The Honourable James M. Flaherty
Minister of Finance
L'Esplanade Laurier, East Tower
140 O'Connor Street
Ottawa, ON
K1A OG5

Dear Minister:

Re: Outstanding Income Tax Proposals

On behalf of the Joint Committee on Taxation, we are writing with respect to income tax proposals of the previous Government that have been outstanding for a number of years. To provide certainty to taxpayers and their advisers, we urge the Government to announce at the earliest opportunity its intentions with respect to those proposals. We further urge the Government to defer certain of the proposals, and to proceed expeditiously with the enactment of the remaining proposals that the Government intends to implement.

Background on the Joint Committee

The Joint Committee on Taxation is a joint committee of the Canadian Institute of Chartered Accountants (CICA) and the Canadian Bar Association (CBA) and is comprised of senior income tax professionals from both organizations. The Joint Committee's primary role is to provide input to the Department of Finance and the Canada Revenue Agency with respect to income tax matters. That input includes identifying concerns with amendments to the Income Tax Act and Regulations proposed by the government, as well as making proposals for amendments to address issues of a technical nature raised by members of the tax community. For the most part, we provide our input by way of written submissions, many of which are made to the Tax Policy Branch of your Department. In addition, we meet from time to time with officials of the Department of Finance and the CRA.

Outstanding Proposals

The legislative proposals that are of concern to us have been outstanding from 2-1/2 to 6 years. They are:

- **Deductibility of interest and other expenses.** These proposals were released in October 2003, and were to be effective for taxation years beginning after 2004. The February 2005 budget indicated that the proposals would be replaced by "a more modest legislative initiative", but did not defer the effective date.

- **Foreign investment entity and non-resident trust rules.** The first draft of these rules was released in June 2000, and the most recent draft was released in July 2005. These rules are generally intended to apply to taxation years that begin after 2002.

- **Foreign affiliate amendments.** These proposed amendments were first released in December 2002, and a revised and expanded draft was released in February 2004. Many of these amendments are intended to apply commencing in 2003, and taxpayers can make an election to have a number of the amendments apply to taxation years that begin after 1994.

- **General technical amendments.** The first draft of these amendments was released in December 2002, and the most recent draft was released in July 2005. Many of these amendments are to take effect in 2003 or earlier.

Uncertainty for Taxpayers

As you can no doubt appreciate, these legislative proposals create substantial uncertainty for taxpayers and their advisers as to the tax consequences of particular transactions and arrangements. The existence of this uncertainty is attributable to: the long period of time during which these proposals have been in draft form; the revisions that have been made periodically to the proposals; the extensiveness and complexity of the proposals; and the fact that the proposals are generally applicable to past taxation years. The uncertainty is heightened further by the absence of a statement from the new Government as to its intentions with respect to the proposals.

As the Supreme Court of Canada stated recently in its decision in the *Canada Trustco* case (one of its decisions dealing with the general anti-avoidance rule), it is a goal of the Income Tax Act to provide sufficient certainty and predictability to permit taxpayers to intelligently order their affairs. While the Supreme Court stated this goal in connection with the interpretation of the Act, it applies equally with respect to proposals to amend the Act. Uncertainty as to the amendments that will be made to the Act makes it difficult for taxpayers to intelligently order their affairs. A further reason for the concern with the uncertainty that currently exists is the difficulties it creates for the preparation of financial statements.

Reducing the Uncertainty

To reduce the uncertainty, we request that you take the following steps:

1. Announce as soon as possible which of the above proposals the Government intends to proceed with. For the purpose of the following, we will assume that the Government intends to proceed with all the proposals.

2. Defer the effective date for the proposals relating to the deductibility of interest and other expenses to a time that is after the release of the revised proposals. We submit that it is inappropriate for any limitation on deductions to take effect before the details of the proposed limitation have been announced.

3. Split the foreign affiliate amendments into two separate packages: (i) technical and other non-controversial amendments; and (ii) amendments of a more substantive nature that require further consultation. The foreign affiliate amendments are extensive, running to over 200 pages in the most recent draft. The splitting of the amendments as suggested would enable the Government to proceed with the enactment of the amendments that have been settled while consultations continue on the other amendments. We note that this is a suggestion we previously made to the Director of the Tax Legislation Division in a letter dated October 8, 2004 (copy attached). In addition, the effective dates for the amendments on which consultations are to continue should be deferred until the final details of those proposals have been settled.

4. Introduce a bill into Parliament in the near future to implement the foreign investment entity and non-resident trust rules, the general technical amendments, and the technical part of the foreign affiliate amendments.

Foreign Investment Entity Rules

The proposed foreign investment entity rules are exceedingly complex, and extend far beyond the originally announced purpose of ensuring that Canadians cannot avoid income tax by transferring funds to offshore trusts or accounts. As noted by the Tax Executives Institute (TEI) in their letter to you of March 23, 2006, these rules implement a "comprehensive new regime for taxing indirect foreign investment". Moreover, there have been numerous changes to the proposed rules from draft to draft (five drafts in total). Given the complexity of the rules, the uncertainty as to the final form they will take, and the compliance burden imposed by the rules, many taxpayers have filed their tax returns without taking the proposed rules into account. If the Government proceeds with the foreign investment entity rules, we submit that taxpayers should not be expected to amend their prior tax returns, something that could be quite onerous to do. Accordingly, we concur with the TEI recommendation that these rules (or any revised version of them) take effect no earlier than taxation years commencing after 2006.

Relief from Interest and Penalties

A number of the proposed amendments, in addition to those which we have requested be deferred, have retroactive effective dates. For example, the non-resident trust rules are to apply to taxation years beginning after 2002. When the retroactive amendments are enacted, taxpayers who have chosen to file their tax returns on the basis of the law in force at the time of filing, rather than the law as it is proposed to be amended, may be liable for additional tax in respect of prior taxation years. Late payment interest would be payable in respect of this additional tax. Moreover, some taxpayers, such as non-resident trusts to which the existing rules do not apply but the proposed rules will apply, may not have filed tax returns. These taxpayers may be liable not only for interest in respect of the tax payable by them, but also for late-filing penalties. We submit that taxpayers in these situations should not be required to pay interest or penalties. Their reliance on existing law rather than the law as it might be retroactively amended is entirely reasonable and in accordance with the principle of the rule of law. Hence, they should not be subject to interest and penalties for having done so. The relief from interest and penalties could be provided either by having the CRA publicly announce that it will waive these amounts, or by including a specific relieving provision in the legislation.

Consultations with Tax Policy Branch

Finally, we should note that the Joint Committee values the consultations undertaken by the Tax Policy Branch, and in particular by the Tax Legislation Division of that Branch, with respect to these proposals. In raising the concerns outlined in this letter, it should be understood that we are not in any way criticising the consultation process. We commend Department officials for their willingness to engage in open and full discussion on the proposed legislation throughout the consultations, and we look forward to continuing to work with them.

We would be pleased to meet with you or your officials to discuss the submissions made in this letter further.

Yours truly,

Paul B. Hickey, C.A.
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

William R. Holmes
Chair, Taxation Section
Canadian Bar Association

Bruce Harris, C.A.
Vice-Chair, Taxation Committee
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Patrick Boyle
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cc: David McLaughlin,
Chief of Staff
Minister of Finance's Office

cc: Bob Hamilton
Assistant Deputy Minister
Tax Policy Branch
Department of Finance

cc: Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch
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October 8, 2004

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

Dear Mr. Ernewein:

Re: February 27, 2004 Draft Legislation (the "Draft Legislation")-- Proposed Amendments to the Foreign Affiliate Rules

We would like to first of all thank you for taking the time to meet with us on September 27, 2004, on the occasion of the Annual Conference of the Canadian Tax Foundation in Toronto. We appreciate your receptiveness to the process of discussing outstanding legislative issues with us from time to time.

Among the various matters discussed at that meeting, we noted our continuing concerns with respect to certain aspects of the proposed amendments to the foreign affiliate rules. While many of the proposed amendments are technical and relieving in nature, others seem to introduce restrictive – and, in some cases, unduly burdensome – departures from current rules and underlying principles. Moreover, we noted during the meeting that, in our view, while many of the proposed amendments would seem to be refined enough at this point to merit proceeding forward to the Technical Bill stage, certain of the proposals, as currently structured or drafted, would in many cases appear to be ineffective, overly disruptive of the scheme of the Act and Regulations in this area, and/or fiscally punitive. In particular, we note the following principal areas of concern:

- The proposed amendments with respect to "internal dispositions" would operate on the basis of a "suspended income and gains" mechanism, the introduction of which would in our view result in numerous anomalies in the distribution of economic values and tax attributes within a chain of foreign affiliates. In addition, we are aware of examples where this approach could result in the punitive taxation as FAPI of gains which accrued on excluded property, as well as in the complete ineffectiveness of the proposed amendments. These anomalies would in our view arise because of structural aspects of the approach being adopted, rather than because of drafting issues.

- The proposed amendments with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates would also appear to give rise to anomalous consequences in many cases, as a result of certain structural aspects of their formulation. In this context, we have seen examples of transactions that would result in the imposition of taxation under the Act in circumstances involving no more than a simple corporate combination or other reorganization that does not in any substantive way alter the indirect economic relationship between the relevant assets or surplus and the relevant taxpayer(s), as well as examples where radically different consequences would arise under the Act or the Regulations depending on whether a merger rather than a liquidation or other reorganization transaction is implemented even though the exact same corporate and commercial result would be achieved either way.

- The proposed amendments with respect to adjustments to be made to the various surplus and other accounts of a foreign affiliate as a result of the application of the subsection 93(1) deemed dividend rules, and in the context of certain changes to a relevant taxpayer's surplus entitlement percentage, would also appear to result in anomalous consequences in certain cases, including the over-attribution of underlying deficits and, more generally, the "scrambling" of surplus accounts. In addition, these measures would appear to introduce inordinate uncertainty, complexity and administrative and compliance costs into the system.

We believe that an alternative approach could be devised for "internal dispositions" that could address the concerns of Finance in this regard in a manner that would not give rise to such anomalies. Similarly, we believe that the concerns of Finance with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates could be addressed in a more conceptually coherent manner, and more consistently with certain of the fundamental principles that underlie the scheme of the Act and Regulations in this area. We also believe that Finance's concerns with respect to the surplus account adjustment rules could be addressed in a more efficient manner, that would not disrupt the relationship between tax attributes and economic values, and therefore would be more consistent with the underlying purpose of these rules.

Although we have had certain initial and informal discussions and correspondence with officials of your Department to this effect, we believe that additional representations are warranted in the circumstances. We are quite busy preparing a relatively comprehensive submission on the foreign affiliate proposals that covers a broad range of relevant technical and policy considerations, as well as a separate submission on the other (non-foreign affiliate) aspects of the Draft Legislation. Both should be finalized in the coming few weeks.

At the meeting on September 27 we suggested the possibility of severing certain aspects of the proposed amendments from the coming Technical Bill, such that they may be considered in greater depth, while the balance of the proposals proceed through the legislative process. We would strongly encourage you to adopt this approach, and would recommend for your consideration in this regard severing the three issue areas described above.

We would be pleased to elaborate on our thoughts in this regard, including with respect to transitional issues, should you consider it to be advisable to entertain this possibility further.

Yours truly,

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Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Brian R. Carr
Chair, Taxation Section
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cc: Mr. Bob Hamilton, Assistant Deputy Minister, Tax Policy Branch, Department of Finance Canada
Mr. Len Farber, General Director, Tax Legislation Division, Tax Policy Branch, Department of Finance Canada