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June 30, 2006

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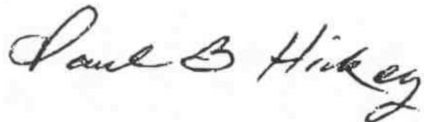
Dear Mr. Ernewein:

Re: Proposals for Next Technical Amendments Bill

The enclosed submission identifies a variety of technical concerns with provisions of the Income Tax Act raised by members of the tax community and it proposes amendments to address the concerns. We hope that this submission can be considered in connection with the preparation of the next technical amendments bill.

The Joint Committee would welcome the opportunity to meet with you and your colleagues to discuss the concerns raised in this submission.

Yours truly,



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CICA – CBA Joint Committee on Taxation
Proposals for Technical Amendments

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A. Personal Taxation

A.1 Tuition/Education Tax Credits and Foreign Tax Credits

In general terms, the amount of tuition and education tax credits that an individual can carry forward to subsequent taxation years is equal to the credits carried forward from prior years plus credits arising in the current year, minus the amount of tax that would be payable by the individual under Part I for the current year if no amount were deductible in respect of certain tax credits. In effect, the individual is assumed to use available tuition and education credits to the extent of this notional amount of Part I tax, whether or not the individual in fact does so. The notional amount of Part I tax enters into the determination of the carryforward amount through quantity C in subsection 118.61(1) (which limits current year credits that can be carried forward) and paragraph 118.61(2)(b) (which limits credits carried forward from prior years that can continue to be carried forward).

For the 2001 and earlier taxation years, one of the tax credits that was deductible in determining the notional amount of Part I tax in section 118.61 was the foreign tax credit. Because of this, as well as the manner in which the foreign tax credit is computed – tax otherwise payable for the purpose of the credit is determined using tuition and education tax credits actually claimed, not the maximum amount that could be claimed – an individual was able to claim maximum credits in respect of foreign tax before having to use tuition and education tax credits. The CRA has agreed that this was the result under the pre-2002 rules: see Documents No. 2003-0016537 and No. 2001-0076567.

The proposed amendments to section 118.61 contained in the July 18, 2005 draft Technical Amendments (and included in Bill C-13) will require the notional amount of Part I tax used in that section to be determined for the 2002 and subsequent taxation years on the assumption that no amount is deductible in respect of foreign tax credits. Consequently, taxpayers entitled to claim a foreign tax credit and also tuition and education tax credits in the same year will lose the benefit of all or a portion of their tuition and education tax credits. This is because the amount of tuition and education tax credits that can be carried forward will be determined on the basis that

the credits had been used to offset tax attributable to foreign-source income, even though the taxpayer has a foreign tax credit to offset all or part of such tax.

We submit that it is inappropriate for foreign tax credits to be excluded in determining the notional amount of Part I tax for purposes of section 118.61. The inappropriateness can be seen from the following simplified example. Assume that: (i) in 2003 an individual attends university, pays tuition, and does not earn any income; (ii) the individual works in Canada in 2004 and in a foreign country in 2005 (but remains a Canadian resident); (iii) the individual's foreign tax credit for 2005 exceeds the amount of Canadian tax otherwise payable in respect of the foreign-source income; and (iv) the tax payable by the individual for each of 2004 and 2005, before the deduction of the individual's tuition, education and foreign tax credits, exceeds the tuition and education tax credits available to the individual. In this case, the individual would be able to claim the full amount of his or her tuition and education tax credits in 2004 (carried forward from 2003) and a foreign tax credit in 2005. However, if the individual worked in the foreign country in 2004 and then in Canada in 2005, he or she would lose the benefit of the tuition and education tax credits. This is because the amount of those credits carried forward to 2005 under subsection 118.61(1) would be nil, even though the individual had a foreign tax credit sufficient to offset the full amount of tax otherwise payable for 2004.

Recommendation

Foreign tax credits should continue to be deductible in computing the notional amount of Part I tax used in quantity C in subsection 118.61(1) and in paragraph 118.61(2)(b).

A.2 Deduction for Tuition and Education Tax Credits Carried Forward

Subsection 118.61(2) permits an individual to deduct tuition and education tax credits carried forward, to the extent of the amount of tax that would be payable by the individual under Part I for the current year if no amount were deductible in respect of certain tax credits. One of the amounts that is permitted to be deducted under current and proposed[1] subsection 118.61(2) in

[1] July 18, 2005 Draft Technical Amendments.

determining this notional amount of Part I tax is the amount deductible under subsection 118.61(2) itself. This appears to be circular.

Recommendation

Paragraph 118.61(2)(b) should be amended to exclude, in the determination of the tax payable under Part I, the amount deductible under subsection 118.61(2).

A.3 Tax on Split Income – Excluded Amounts

Income that is an "excluded amount" is excluded from the tax on split income. The term "excluded amount" is defined in subsection 120.4(1) in respect of a particular individual to mean income from any property (an "Excluded Property") acquired by or for the benefit of the individual either as a consequence of the death of a parent of the individual or, if the individual is a full-time student or is disabled, as a consequence of the death of any person.

Income from property that is substituted for an Excluded Property is not an excluded amount. We submit that this is inappropriate.

For example, assume that as a consequence of the death of a parent of a specified individual, a testamentary trust created on the death of the parent has acquired common shares of a taxable Canadian corporation ("Opco") for the benefit of the individual. Subsequently, Opco amalgamates with another corporation to form a new corporation ("Amalco"). In this case, dividends received by the trust on the Amalco shares that are deemed to be dividends received by the individual would not be an excluded amount of the individual. Therefore, the tax on split income would apply with respect to such dividends.

Recommendation

Income from a property should be an excluded amount if the property was substituted for another property and income from that other property would have been an excluded amount.

B. Business/Property Income

B.1 Application of Section 67.6 to Provincial Sales Tax Penalties

The provinces have different statutory mechanisms for enforcing the obligation to collect sales tax. Under the legislation of Ontario and British Columbia, a vendor that fails to collect sales tax is liable for a penalty equal to the amount of sales tax that should have been collected (the penalty includes related interest in the case of B.C.). Pursuant to section 67.6, these penalties are not deductible.

The legislation of other provinces, such as Manitoba, Saskatchewan, and Prince Edward Island, deems a vendor to have collected sales tax if the vendor has not actually done so, and requires the vendor to remit the deemed amount to the government. Since the remitted amount is not a penalty, the vendor should be entitled to claim a deduction for it.

We submit that the amount payable by a vendor who has failed to collect sales tax should be deductible regardless of the mechanism used in a particular province for imposing the obligation on the vendor. In substance, there is no difference between deeming a vendor to have collected tax, and imposing a penalty on a vendor. This “penalty” is simply a collection mechanism for tax, and is not the sort of penalty contemplated by section 67.6

Recommendation

Penalties imposed by provinces for the failure to collect sales tax should be prescribed penalties that are excluded from the application of section 67.6.

B.2 Options Granted by Pooled Investment Trusts

Where a taxpayer grants a call option to another person to acquire property from the taxpayer, and the option is not a type of option described in paragraphs 49(1)(a) to (c), the granting of the option is deemed by subsection 49(1) to be a disposition of property that has an adjusted cost base of nil. Thus, the proceeds from the granting of the option are treated as a capital gain. If the option is subsequently exercised, with the result that the property is disposed of by the taxpayer, subsection 49(3) reverses this capital gain and includes the consideration for the granting of the option in the determination of the taxpayer's proceeds of disposition of the property. Where the granting and the exercise of the option occur in different taxation years, and the taxpayer has realized net taxable capital gains in the year in which the option was granted, the amount of the net taxable capital gains is reduced as a result of the application of subsection 49(3).

This reduction in net taxable capital gains has an adverse tax consequence for the unitholders of pooled investment trusts. Such trusts (other than mutual fund trusts) distribute all their income each year, so that the income is taxable in the hands of the trust's unitholders and not in the trust. If subsection 49(3) applies after the end of the year and, as a consequence, the trust's income for the year is reduced, the trust cannot revise the distributions it has made to its unitholders. The distributions will exceed its income, with the result that a portion of the distributions will be non-taxable capital distributions. Generally, however, it will not be feasible for a trust to correctly report the distributions on T3 slips, because of the onerous compliance burden, particularly where T3 slips have been prepared before subsection 49(3) applies. The result is that the trust's unitholders will include an excess amount of income in their tax returns, since they will rely on the information on the T3 slips.

Mutual fund trusts retain a portion of their net taxable capital gains each year, to the extent that the tax on the retained gains is refundable under subsection 132(1). Where a trust's net taxable capital gains for a year are reduced after the end of the year as a result of the application of subsection 49(3), the consequence is that the trust will have distributed more of its income than it

needed to. In other words, the trust will not have retained the maximum amount of net taxable capital gains that would result in refundable tax.

Recommendation

Pooled investment trusts (or alternatively, all taxpayers) should be permitted to elect not to have subsection 49(3) apply.

B.3 Deduction of Contingent Interest

An accrual basis taxpayer who is contingently obligated at the end of a taxation year to pay interest in respect of the year on borrowed money used for an eligible income-earning purpose is not permitted to deduct the interest in the year. The reason is that paragraph 20(1)(c) permits a deduction for interest only if the interest is payable in respect of the year pursuant to a legal obligation to pay the interest. The non-deductibility of contingent interest has been confirmed by the courts: *Barbacan Properties Inc. v. The Queen*, 97 DTC 5008 (FCA), and *Redclay Holdings Limited v. The Queen*, 96 DTC 1207 (TCC). Furthermore, if the obligation to pay the interest becomes absolute in a subsequent taxation year, the taxpayer is not permitted to deduct the interest in that subsequent year since it is not payable in respect of that year: *M.N.R. v. Mid-West Abrasive Company of Canada Limited*, 73 DTC 5429 (FCTD). As indicated in paragraph 6 of IT-533, the CRA agrees that paragraph 20(1)(c) applies as just described.

It is arguable that once the obligation to pay interest becomes absolute, the interest is then deductible in the year it accrued. Even if the CRA were to agree with this, and to allow an amended tax return to be filed, it is a very impractical solution. Taxpayers would be relying on the CRA position, and would have to file waivers in respect of the affected years, to preserve the ability to go back and claim the interest deduction.

We submit that this treatment of contingent interest is inappropriate. Taxpayers should be permitted to deduct such interest when the obligation to pay the interest becomes absolute.

Recommendation

We recommend that a rule be added allowing the deduction of contingent interest in the year that the obligation to pay the interest becomes absolute.

B.4 Replacement Property Rules

Under the replacement property rules in subsection 13(4) and section 44, a taxpayer is permitted to defer the tax consequences of a disposition of property if the taxpayer acquires a replacement property within a specified period of time. The acquisition of the replacement property can occur after the year in which the disposition occurred. In this case, the taxpayer makes the election to have the replacement property rules apply in the taxpayer's return for the year in which the replacement property is acquired. However, there is no provision in the Act requiring the CRA to reassess the taxpayer for the year of disposition to give effect to the election.

Recommendation

We recommend that a provision analogous to subsection 152(6) be added to the Act requiring the CRA to reassess to give effect to a replacement property election.

B.5 Foreign Currency Gains and Losses

Subsection 39(2) deems gains and losses arising from foreign currency fluctuations (other than income account gains and losses) to be capital gains and losses from the disposition of foreign currency. In the case of a taxpayer who is an individual, subsection 39(2) excludes the first $200 of net gain or loss realized each year.

Subsection 39(2) appears to apply to foreign-currency related gains and losses realized on the disposition of property, as well as to such gains and losses realized in respect of liabilities. The application to dispositions of property is, we submit, unnecessary, since the effect of foreign currency fluctuations is already taken into account under the general rules for determining capital gains and losses. Pursuant to *Gaynor v. The Queen*, 91 DTC 5288 (FCA), the cost of a property

is to be determined in Canadian dollars using the exchange rate in effect at the time of acquisition, while the proceeds of disposition are to be determined in Canadian dollars using the exchange rate at the time of disposition. Thus, the effect of any change in exchange rate is reflected in the gain or loss realized on the disposition of the property.

For a discussion of the issues and the confusion that arise if subsection 39(2) applies to dispositions of property, we refer you to two articles:

- Robert A. Kopstein and Janette Y. Pantry, "Foreign Exchange Issues," 2003 Conference Report of the Canadian Tax Foundation, at 27:23-33, and
- David G. Broadhurst, "Foreign Exchange Planning," in Tax Planning for Canada-US and International Transactions, 1993 Corporate Management Tax Conference, at 8:23-25.

Recommendation

We recommend that subsection 39(2) be restricted to liabilities and to monetary assets of individuals (so that the exemption for small net gains and losses is applicable in respect of such assets). In addition, we suggest that the $200 be updated to reflect inflation since this amount was enacted.

C. Trusts and Estates

C.1 Acquisition of Control by Trust

In a recent technical interpretation (2004-0087761E5), the CRA concluded that a change in any of the trustees of a trust that holds sufficient voting shares to control a corporation could result in an acquisition of control of the corporation. This position gives rise to the concern that there will be acquisitions of control in many situations where this is inappropriate.

We are also concerned with the implication of the CRA's position for situations where shares are transferred from an estate to a trust created by the will of the deceased, or from one trust to another trust. If the trustees of the recipient trust are not related to the transferor executors or trustees, the CRA would presumably apply the same position as it applies to a change of trustees. Again, the result is that acquisitions of control will be considered to occur in circumstances where this is inappropriate.

We submit that, in general, an acquisition of control should not be considered to occur by virtue of a change of the trustees of a trust or a transfer of shares from an estate or trust to a trust. Rather, it should be certain changes of beneficiaries that trigger an acquisition of control. In this regard, there are a number of provisions in the Act that look to the beneficiaries of a trust and not the trustees. These include subparagraph 55(5)(e)(ii), paragraph 191(3)(d) and paragraph 251.1(1)(g) (together with paragraph 251.1(4)(c)). Subparagraph 55(5)(e)(ii) deems a person to be related to a trust if the person is related to each beneficiary of the trust (other than a registered charity). Paragraph 191(3)(d) deems a trust not to have a substantial interest in a corporation unless each beneficiary of the trust is related to each other beneficiary (other than a registered charity) or is a registered charity. Under paragraph 251.1(1)(g), a person is affiliated with a trust only if the person is a majority-interest beneficiary of the trust or affiliated with a majority-interest beneficiary. Paragraph 251.1(4)(c) provides that the determination of whether a person is affiliated with a trust is to be made without reference to the trustee of the trust.

Recommendation

We recommend that rules be added to prevent acquisitions of control from occurring by virtue of a change of the trustees of a trust or a transfer of shares from an estate or trust to a trust. Instead, acquisitions of control should be deemed to occur in certain circumstances where there is a change of beneficiaries. We recognize that these rules may need to include anti-avoidance provisions.

C.2 Foreign Tax Credit of Beneficiary for Business-Income Tax Paid by Trust

Where a resident trust that carries on a business in a country other than Canada distributes all or part of its income for a year from the business to a resident beneficiary, it appears that, for a technical reason, the beneficiary may not be entitled to claim a foreign tax credit in respect of foreign tax paid by the trust in respect of the income. The credit, if available, would be provided by subsection 126(2). That subsection applies to a taxpayer only if the taxpayer *carried on business* in a country other than Canada. Moreover, the credit is available only for business-income tax paid by the taxpayer *in respect of businesses carried on by the taxpayer*. Subsection 126(2.1), which specifies amounts for the purpose of paragraph 126(2)(b), also refers to businesses carried on by the taxpayer.

While subsection 104(22) deems the distributed income to be income of the beneficiary from the trust's business for purposes of the foreign tax credit rules if the trust makes the applicable designation, it does not deem the beneficiary to carry on the trust's business. Furthermore, while subsection 104(22.1) deems the beneficiary to have paid a portion of the business-income tax paid by the trust in respect of the income from the business, it does not deem the business-income tax to have been paid in respect of a business carried on by a taxpayer. Thus, these deeming rules do not provide a complete basis for the beneficiary to claim foreign tax credits under subsection 126(2).

This issue also exists with respect to the special foreign tax credit in section 127.54 for purposes of the alternative minimum tax. A further issue is that it appears that subsection 104(22) does not apply for the purpose of the definition of "foreign income" in subsection 127.54(1).

Recommendation

We recommend that further deeming rules be added to section 104 so that a beneficiary of a trust meets all the requirements to claim foreign tax credits in respect of foreign business income of the trust distributed to the beneficiary.

C.3 Deduction by Beneficiary of Excess Non-Business-Income Tax

Subsection 104(22.1) deems a beneficiary of a trust to have paid a portion of the non-business-income tax paid by the trust. However, this deeming is only for the purposes of subsection 104(22.1) and section 126. Thus, a beneficiary is not able to claim a deduction under subsection 20(12) in respect of the non-business-income tax that the beneficiary is deemed to have paid. There does not appear to be any policy reason for this limitation.

Recommendation

Subsection 104(22.1) should be amended to include a reference to subsection 20(12).

C.4 Benefits under Trusts

Subsection 105(1) is a broadly worded provision that includes the value of benefits from or under a trust in the income of a taxpayer. Certain benefits are excluded from this provision, including those that are otherwise required to be included in the taxpayer's income and those that result in a reduction in the adjusted cost base of the taxpayer's interest in the trust. The companion rule in subsection 105(2) provides that amounts paid out of the income of a trust for the upkeep, maintenance and taxes in respect of a property are to be included in the income of the beneficiary for whose use the property is maintained.

Subsection 105(1) could potentially apply in a wide range of situations. In one limitation of its scope, the CRA has said that the subsection generally does not apply to the benefit associated with the rent-free use of personal-use property owned by a trust (Income Tax Technical News No. 11).

It is not apparent to us why subsection 105(1) is required. The rules in section 104 and subsection 105(2) ensure that all income earned by a trust is taxable, either in the hands of the trust or in the hands of its beneficiaries. The effect of subsection 105(1) is either to cause income to be taxed a second time (after the year in which it has been earned), or to cause capital of the trust to be taxed. Both of these results are inappropriate.

Recommendation

We recommend that subsection 105(1) be reviewed to determine if there continues to be any valid purpose for this provision. If there is no such purpose, it should be repealed. Otherwise, it should be amended to clearly delineate its scope of application.

D. Partnerships

D.1 Subsection 40(3.12) Elective Capital Loss – Tiered Partnerships

Subsection 40(3.12) permits a corporation or an individual (other than a trust that is not a testamentary trust) that is a member of a partnership to elect to be deemed to have a loss from a disposition of its interest in the partnership. This election is available if the partner was deemed by subsection 40(3.1) to have a gain in a previous year because the partner's adjusted cost base (ACB) of its interest in the partnership was "negative". The amount of loss that can be elected under subsection 40(3.12) is limited to the ACB of the partner's partnership interest.

The election under subsection 40(3.12) is not available to a partnership that is a partner of another partnership, nor is it available to a partner of the top-tier partnership in respect of the interest in the lower-tier partnership. For example, assume that Mr. X is a partner of Partnership A, which is a general partnership. Partnership A is a limited partner of Partnership B. The fiscal period of each partnership is the calendar year. At the end of 2005, the ACB of Partnership A's interest in Partnership B was a "negative" amount of $1,000 because Partnership B distributed all of its income to its partners in 2005. Consequently, subsection 40(3.1) applied to deem Partnership A to realize a capital gain of $1,000 and, in accordance with subsection 96(1), Mr. X was required to include his share of the taxable capital gain in income in addition to his share of Partnership B's income for 2005. Assume further that, at the end of 2006, the ACB of Partnership A's interest in Partnership B is $1,000. In this case neither Partnership A nor Mr. X can elect under subsection 40(3.12) to be deemed to realize a loss. This limitation on the application of subsection 40(3.2) does not seem appropriate.

We note that the root cause of the problem in the above example is that Partnership B's income for 2005 is not added to the ACB of Partnership A's interest in Partnership B until after the end of 2005.

Recommendation

We recommend that subsection 40(3.12) be amended to permit partnerships that are members of other partnerships to make the election under that subsection.

D.2 Emigration and Subsection 96(1.1) Rights

On ceasing to be a resident of Canada, an individual who holds a right to a share of the income of a partnership described in subsection 96(1.1) is deemed by paragraph 128.1(4)(b) to have disposed of that right for fair market value proceeds and is deemed by paragraph 128.1(4)(c) to have reacquired that right at a cost equal to that amount. Unlike certain other rights, a right described in subsection 96(1.1) is not an "excluded right or interest" as defined in subsection 128.1(10), and so is not excluded from the deemed disposition and reacquisition. As a result of the deemed disposition of the right, the individual is required by subsection 96(1.2) to include the fair market value of the right in income.

Partnership income allocated to the individual pursuant to the right after the individual has ceased to be a Canadian resident will be subject to tax in Canada as income from a business carried on in Canada. In this regard, subsection 96(1.6) deems the individual to carry on business in Canada. The individual will be entitled to an offsetting deduction in respect of such income pursuant to subsection 96(1.3), to the extent of the amount included in the individual's income as a result of the deemed disposition on emigration. The CRA has confirmed that this is how the present rules apply: see Technical Interpretation 9801445.

We submit that it is inappropriate for the deemed disposition and acquisition rules to apply to rights described in subsection 96(1.1). Since the individual holding such a right continues to be subject to tax in Canada in respect of his or her share of partnership income after ceasing to be a

Canadian resident, there is no need to accelerate the taxation in respect of the right when the individual ceases to be a Canadian resident.

Recommendation

A right to a share of partnership income described in subsection 96(1.1) should be excluded from the deemed disposition and acquisition rules that apply on the migration of a taxpayer. This could be implemented by adding such rights to the definition of "excluded right or interest" in subsection 128.1(10).

E. Corporations

E.1 Capital Dividend Election

The capital dividend election under subsection 83(2) must be made in respect of the *full* amount of a dividend. This gives rise to a problem where the dividend in respect of which the election is made is a deemed dividend arising on the redemption of shares. Often the deemed dividend will exceed the balance in the capital dividend account or the amount that is intended to be a capital dividend. While there are solutions – such as an initial increase in paid-up capital so as to reduce the deemed dividend on redemption – these solutions can be inconvenient. It would be desirable if the election could be made in respect of a portion of a dividend.

Recommendation

We recommend that subsection 83(2) be amended to permit an election in respect of a portion of a dividend. Consequential changes may need to be made to provisions that refer to subsection 83(2), such as paragraph 53(2)(a) and the definition of "taxable dividend" in subsection 89(1).

E.2 Election re Excess Capital Dividend

Where a corporation makes an election under subsection 83(2) in respect of a dividend, and the CRA subsequently assesses the corporation under Part III on the basis that the dividend exceeded the corporation's capital dividend account, the corporation is permitted to make an election under subsection 184(3) to have the excess portion of the dividend treated as a taxable dividend. The election must be made within 90 days after the mailing of the notice of assessment. This deadline is problematic where a corporation chooses to object to the Part III assessment. If the corporation is unsuccessful, it does not have a right to make an election under subsection 184(3) at the end of the proceedings.

A corporation may disagree with the CRA's determination of its capital dividend account where, for example, the amount in the account depends on whether a particular transaction was on income or capital account. In this case, the corporation would object to the Part I reassessment (assuming the recharacterization of the gain or loss affects the amount of tax payable for the year), and at the same time would object to the Part III assessment.

At present, a corporation in this situation could attempt to file a "contingent" election under subsection 184(3), i.e., an election that is intended to be effective only if the corporation is unsuccessful in disputing the Part III assessment. It is unclear whether such an election would be valid. Even if it is, the election is not a satisfactory solution because the corporation may be partially successful, and so may have over elected.

The other alternative is for the corporation to seek to late file a subsection 184(3) election pursuant to the fairness provisions. This alternative is unsatisfactory because it leaves the acceptance of the election to the discretion of the CRA.

Recommendation

We recommend that the deadline for filing a subsection 184(3) election be extended where a taxpayer objects to an assessment under Part III. The deadline should be 90 days after the final

determination of the amount of the excess dividend. Where a taxpayer has a right to appeal from a decision of the CRA or a court but chooses not to appeal, the final determination should not be considered to have been made until the expiry of the taxpayer's appeal right.

E.3 Affiliated Corporations in an Amalgamation Context

Where two or more corporations amalgamate, it is necessary for the purposes of certain rules to determine whether the new corporation formed on the amalgamation was affiliated with one or more of the predecessor amalgamating corporations. Subsection 251.1(2) deems the new corporation to have been affiliated with a predecessor corporation where the two corporations would have been affiliated immediately prior to the time of amalgamation if the new corporation had been in existence and its shareholders had been the persons who were its shareholders immediately after the amalgamation. This affiliation test will not be satisfied where a predecessor corporation is widely held, and consequently such a predecessor corporation will not be deemed to have been affiliated with the new corporation.

The following is an example where the non-affiliation of a widely-held precedessor corporation with the new corporation could be problematic. A widely-held public company (Pubco) has accumulated losses and its wholly-owned subsidiary (Subco) has an asset with an accrued gain. If Pubco and Subco were to amalgamate to form a new corporation (Amalco), and then Amalco were to sell the asset and use its losses to shelter the gain from the sale of the asset, subsection 69(11) may apply to deem Subco to have disposed of the asset for fair market value proceeds.

For the purpose of determining if amalgamating corporations would have been *related* to the new corporation if they had been in existence at the same time, subsection 251(3.1) contains a rule similar to that in subsection 251.1(2). A further rule, in subsection 251(3.2), provides that if the amalgamating corporations were related to each other immediately before the amalgamation, the new corporation is deemed to have been related to each of the amalgamating corporations.

Recommendation

A rule similar to subsection 251(3.2) should be added to section 251.1. The rule would deem the new corporation formed as a result of an amalgamation to be affiliated with each of the amalgamating corporations, if the amalgamating corporations were affiliated with each other immediately prior to their amalgamation.

E.4 Taxable Preferred Shares – Minority Discounts

It is not uncommon for private companies to provide a repurchase program whereby each year the company agrees to repurchase a portion of the common shares held by each shareholder. The purchase price is often determined by a formula which is designed to estimate the fair market value of each common share on a pro-rata basis, without regard for the number of shares held or sold by each shareholder.

There is a concern that such a repurchase program could cause the common shares of a corporation to be subject to the taxable preferred share ("TPS") rules. Since the shareholders of the private corporation would generally not have a substantial interest (as defined in subsection 191(2)) in the corporation, Part VI.1 tax could apply.

A common share of a corporation may be a TPS if the corporation is or may be required to acquire the share within a 5-year period. In this case, the share would be a TPS by virtue of being a short-term preferred share ("STPS"). A common share may also be a TPS where the amount the shareholder is entitled to receive in respect of the share on the acquisition of the share is, by way of a formula or otherwise, fixed. However, there are relieving provisions in the definitions of both STPS and TPS. Share purchase terms in an agreement are to be disregarded if the purchase price to be paid for shares will not exceed the fair market value of the shares at the time of the acquisition (determined without reference to the agreement) or if the purchase price is to be determined by reference to the assets or earnings of the corporation where that determination may reasonably be considered to be used to determine an amount that will not exceed the fair market value of the shares at the time of the acquisition (determined without reference to the agreement).

The concern with a repurchase program causing shares to be TPS stems from the fact that a minority discount is not taken into account in determining the price to be paid to individual shareholders. The CRA has taken the position in a technical interpretation (2004-010851) that minority discounts are required to be taken into account in applying the relieving provisions, where such discounts are required by valuation principles.

We submit that it is inappropriate for a share to become a TPS simply because of the existence of a repurchase program of the sort described above under which the purchase price for shares is determined without taking a minority discount into account. This is not the sort of arrangement at which the taxable preferred share rules are aimed.

Recommendation

We recommend that the relieving rules referred to above in the definitions of STPS and TPS be amended so that they apply on the basis of the fair market value of shares determined without taking into account any minority discount. This change could apply to all situations, or it could be limited to situations where a corporation has implemented a share repurchase program.

E.5 Definition of "Specified Financial Institution" – Factoring Corporations

Paragraph (g) of the definition of "specified financial institution" (SFI) in subsection 248(1) provides that a corporation that is related to an SFI is itself an SFI. However, paragraph (g) does not apply to a corporation where the SFI to which it is related is a factoring corporation that has as its principal business the factoring of trade accounts receivable that meet three conditions. This exclusion was added in 1998. The accompanying explanatory notes stated that "where a corporate group establishes a separate corporation to buy and trade receivables from operating companies in the group, for the purposes of either collecting the receivables or selling them to third parties, it is not intended that the operating companies, for that reason alone, be treated as specified financial institutions for the purposes of the Act".

We submit that to fully implement this policy, a similar amendment should be made to paragraph (f) of the definition. Paragraph (f) provides that a corporation controlled by one or more SFIs described in paragraphs (a) to (e.1) of the definition is itself an SFI. "Control" is given a broad meaning for this purpose.

The following example illustrates the issue with paragraph (f). Assume that a corporation ("Parent") owns all of the shares of two subsidiary corporations. One subsidiary is a factoring company ("FactorCo") and the other subsidiary is an operating company ("Opco"). FactorCo and Opco are related because they are both controlled by Parent. FactorCo acquires trade account receivables only from Opco.

FactorCo is a corporation described in paragraph (e) of the definition of SFI. Since the receivables acquired by FactorCo meet the conditions listed in paragraph (g) of the definition, neither Parent nor Opco is an SFI by virtue of that paragraph. For the purpose of paragraph (f) of the definition, FactorCo is considered to control Opco because more than 50% of Opco's issued shares having full voting rights belong to a person, namely Parent, with whom FactorCo does not deal at arm's length. Thus, Opco is an SFI pursuant to paragraph (f).

Recommendation

We recommend that paragraph (f) of the definition of SFI be amended to contain an exclusion similar to that in paragraph (g).

E.6 Cost Issues Included in January 27, 2006 Submission Regarding Section 143.3

In Sections F and G of our January 27, 2006 submission we identified and discussed certain issues related to the cost of property (including cash) acquired by a corporation as a contribution of capital or distributed by a corporation on a reduction of capital. The Department of Finance officials with whom we discussed the submission indicated that these issues would be considered separately from the issues relating to proposed section 143.3. Our purpose in noting these issues here is to ensure that they are not overlooked.

F. Miscellaneous

F.1 Salary Deferral Arrangement – Prescribed Plans (Regulation 6801(d))

Regulation 6801(d) prescribes certain equity-based deferred compensation arrangements for exclusion from the definition of "salary deferral arrangement" in subsection 248(1). Such arrangements are commonly referred to as "deferred share unit plans" or "phantom stock plans". This exclusion applies only to arrangements that are implemented by corporations and that are based on shares of corporations. Specifically, to be prescribed, an arrangement must be between a corporation and an employee of the corporation or a related corporation. Furthermore, amounts payable under the arrangement must depend on the fair market value of shares of the corporation that has entered into the arrangement (or of a corporation related to it).

Equity-based deferred compensation arrangements entered into by mutual fund trusts with their employees do not qualify for this exclusion from the salary deferral arrangement rules. We submit that the exclusion should be extended to encompass such arrangements, and to allow units of a mutual fund trust to be used as the reference equity security. The extension of the exclusion in this way would be consistent with the policy underlying the exclusion. It would also be consistent with the extension a few years ago of the employee stock option rules to options to acquire units of mutual fund trusts.

Recommendation

We recommend that Regulation 6801(d) be extended to apply to arrangements entered into by mutual fund trusts with their employees (or employees of a corporation controlled by the trust) and to allow units of a mutual fund trust to be used as the reference equity security.

F.2 "Compensation" for Purposes of Registered Pension Plan Rules

Certain of the registration rules for pension plans refer to the "compensation" of an individual. For example, compensation is a factor in the pension adjustment limits in subsection 147.1(8).

The amount of an individual's "compensation" from an employer for a year is defined for these purposes in subsection 147.1(1).

In applying the registration rules to a particular pension plan, it is only compensation from employers who participate in the plan that is taken into account. However, the definition of "compensation" allows, in certain circumstances, remuneration from a non-participating employer to be included in determining an individual's "compensation" from a participating employer. Specifically, paragraph (c) of the definition provides that an amount of remuneration received by an individual from *any* employer can be included as compensation of the individual from a particular employer if the remuneration is for a period throughout which the individual is not resident in Canada and the amount is acceptable to the Minister of National Revenue. We understand that this is intended to accommodate situations such as those where an employee of a participating Canadian employer is transferred out of the country for a period of time and works for an affiliated foreign company that does not participate in the registered pension plan. The CRA's Registered Plans Newsletter 93-2 provides information on when remuneration from one employer will be accepted for inclusion under paragraph (c) in determining the compensation of an individual from another employer.

We submit that paragraph (c) is too narrow. It applies with respect to an individual only if the individual is not resident in Canada. However, in some cases, employees who are transferred to affiliated foreign companies will continue to be Canadian residents. The same rationale exists for allowing remuneration received by such employees to be included in compensation from participating employers.

Recommendation

We recommend that paragraph (c) of the definition of "compensation" in subsection 147.1(1) be amended to allow the remuneration of an individual from one employer to be included in determining the individual's compensation from another employer regardless of whether the individual is resident or non-resident when the remuneration is earned.

F.3 Amendment to Subparagraph (b)(i) of the Definition of "Disposition"

The July 18, 2005 draft Technical Amendments include a proposal to amend subparagraph (b)(i) of the definition of "disposition" in subsection 248(1) to clarify that a disposition includes a transaction or event by which a share, bond, debenture, note, mortgage or certain other property is "acquired". Currently, subparagraph (b)(i) refers to a transaction or event by which such property is "redeemed in whole or in part or is cancelled".

The extension of subparagraph (b)(i) to property that is "acquired" may have an adverse consequence for some amalgamations where one of the predecessor corporations owns property referred to in subparagraph (b)(i). It is clear from various paragraphs in subsection 87(2) that, on an amalgamation, the property of a predecessor corporation is considered to be "acquired" by the new corporation formed on the amalgamation ("Amalco"). Consequently, it appears that by virtue of subparagraph (b)(i), the predecessor corporation will be considered to have disposed of any property referred to in that subparagraph that is acquired by Amalco. Proposed paragraph (n) of the definition of "disposition" would not alter this, except for property that is shares of amalgamating corporations. If Amalco is deemed by subsection 251(3.1) or (3.2) to have been related to a predecessor corporation, paragraph 69(1)(b) would therefore apply to deem the predecessor corporation to have disposed of the property for fair market value proceeds. This result is presumably unintended.

Recommendation

We recommend that it be clarified that a predecessor corporation is not considered to have disposed of property as a result of the acquisition of the property by the new corporation formed on an amalgamation.

F.4 Prescribed Venture Capital Corporations

Subparagraph 6700(a)(vi) of the *Income Tax Regulations* refers to the "*Small Business Venture Capital Act*, Statutes of British Columbia, 1985, c. 56". The reference needs to be updated to "Revised Statutes of British Columbia, 1996, c. 429".

F.5 Liability of Directors where Failure to Withhold

Subsection 227.1(1) provides that "where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or section 153 or 215 … the directors of the corporation … are jointly and severally liable, together with the corporation, *to pay that amount* and any interest or penalties relating thereto." [emphasis added] We are concerned that this provision could be interpreted (at least by the CRA) to impose an obligation on the directors that exceeds the obligation on the corporation. For example, if a corporation fails to withhold tax from the salary of a resident employee, the corporation is liable to pay a penalty for the failure but is not liable to pay the tax that should have been withheld. Subsection 227.1(1) appears to make the directors liable to pay the tax that should have been withheld, since this is the "amount" that is referred to in the subsection.

Recommendation

We recommend that it be clarified in subsection 227.1(1) that the only amounts that the directors of a corporation are required to pay are the amounts that the corporation is required to pay.