The Joint Committee on Taxation of
The Canadian Bar Association
and The Canadian Institute of
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January 30, 2006

Mr. Brian E. Ernewein
Director, Tax Legislation Division
Tax Policy Branch
Department of Finance
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Dear Mr. Ernewein:

Issues for Consideration—July 18, 2005 Draft Technical Amendments

We are pleased to provide the attached submission with respect to the July 18, 2005 Draft Technical Amendments (the "2005 Proposals") for your consideration and review.

We note that many of the provisions of the December 20, 2002 and February 27, 2004 Draft Technical Amendments have been carried over to the 2005 Proposals without reflecting the recommendations made in our submissions on those earlier proposals. Although this submission does not repeat our previous recommendations, we continue to believe that they are valid and ask you to reconsider them. We attach a copy of our previous submissions of May 6, 2003 and December 20, 2004 for your reference.

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

Yours truly,

Paul B. Hickey

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Submission of the
CICA-CBA Joint Committee on Taxation
Regarding July 18, 2005 Draft Technical Amendments

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January 30, 2006

A. Restrictive Covenants

A.1 Previous Concerns Not Addressed

While the proposed rules dealing with restrictive covenants contained in the July 18, 2005 Draft Technical Amendments (the "**2005 Proposals**") reflect a number of material changes from the proposed rules in the February 27, 2004 Draft Technical Amendments (the "**2004 Proposals**"), most of the concerns raised in our submission of December 20, 2004 have not been addressed. We continue to be of the view that significant changes are required to address those concerns, which relate primarily to the breadth of the proposed rules. The rules go far beyond the purpose for which they are being introduced, and represent a significant and unnecessary change to long-standing Canadian tax practice.

In brief, the principal concerns raised in our December 20, 2004 submission are the following:

1. The proposed definition of "restrictive covenant" is overly broad. Consequently, the new rules may apply to commercial arrangements of various types for which the income tax treatment is currently appropriate.
2. Where an amount is described in section 42 (dispositions subject to warranty), that section should apply to the amount rather than the restrictive covenant rules.
3. In some circumstances, proposed subsection 56.4(2) may tax the same amount in the hands of more than one taxpayer. We note that an exclusion has been added in the 2005 Proposals for amounts that have been included in the income of a taxpayer's eligible corporation. This exclusion represents a very modest limitation on the potential for double taxation. Indeed, the very presence of this exclusion supports the view that double taxation can occur in other circumstances.
4. There is no election to treat all or part of a non-competition payment as a capital gain when the payment is received by a shareholder in connection with the sale of assets by the corporation. Thus, share sales are favoured over asset sales.

5. The exceptions in proposed subsection 56.4(3) to the income inclusion are too narrow in various respects. We acknowledge that there has been a slight expansion in paragraph 56.4(3)(c) with the addition of an eligible interest in an eligible corporation. However, this expansion covers only a fraction of the situations where a restrictive covenant is given in respect of a business carried on by an entity other than the corporation or partnership that is the direct object of the sale.

6. It is not clear why elections are required in connection with proposed paragraphs 56.4(3)(b) and (c) nor, if the elections are retained, how they can be made or revised following a reassessment that applies section 68 to allocate a portion of consideration to a restrictive covenant. We note that one of our previous concerns with respect to the elections has been addressed: the 2005 Proposals have eliminated the requirement in the 2004 Proposals that an election be filed by both taxpayers.

7. The allocation requirement in amended section 68 is highly impractical, and would introduce substantial uncertainty as to the application of the Act to purchase and sale transactions.

8. Proposed paragraph 60(f) is inconsistent with subsection 56.4(2), in that it does not provide a deduction to a taxpayer who is not the recipient of an amount but is required by subsection 56.4(2) to include the amount in income.

9. We have several concerns relating to the application of Part XIII tax to payments for restrictive covenants. One is that proposed paragraph 212(1)(i), which represents a significant change to the taxation of cross-border payments, is being introduced on a retroactive basis (effective from the October 7, 2003 press release date rather than from February 27, 2004 or later when detailed draft legislation was first made public). Another is that, because restrictive covenant payments are brought into income under subdivision d, it is not clear that such amounts are business profits for the purposes of Canada's tax treaties when the amounts arise in connection with a business carried on by a non-resident.

We refer you to our December 20, 2004 submission for a complete discussion of these and other concerns.

A.2 Exceptions to the Income Inclusion Rule – Tax-Deferred Transfers *(s. 56.4(3))*

Proposed paragraph 56.4(3)(c) applies to an amount only if the amount is added to the taxpayer's proceeds of disposition of the eligible interest (subparagraph (v)). Where a taxpayer grants a restrictive covenant in connection with the tax-deferred sale of an eligible interest, the effect of this requirement is unclear. One view is that it is satisfied if the agreed amount of proceeds of disposition under the applicable rollover provision (subsection 85(1) or 97(2)) equal or exceed the total amount of non-share consideration, including the amount to which proposed subsection 56.4(2) would otherwise apply. Another view is that the requirement can never be met in the case of a tax-deferred transfer, since subparagraph 56.4(3)(c)(v) refers to the proceeds of disposition as defined by section 54. Where a rollover provision applies, the proceeds of disposition are not determined by that definition.

There is no obvious tax policy reason why the relief provided by paragraph 56.4(3)(c) should not be available where a restrictive covenant is granted in connection with a disposition to a corporation that occurs on a tax-deferred basis. To the extent that any non-share consideration is attributable to the restrictive covenant, it should be required to be treated like other "boot". To the extent that the share consideration is attributable to the restrictive covenant, it should not be required that the amount of such shares be added to the proceeds of disposition, i.e., the shares should be treated like the other shares received as consideration. The same comments apply with respect to a rollover to a partnership.

Where a restrictive covenant granted by a taxpayer relates to the sale by the taxpayer of the goodwill of a business on a tax-deferred basis, it appears that proposed paragraph 56.4(3)(b) will not allow rollover treatment for consideration in the form of shares (or a partnership interest). Again, there does not appear to be any tax policy reason for not allowing this.

Recommendation:

We recommend that subsection 56.4(3) be modified to allow the rollover provisions to apply with respect to shares (or a partnership interest) attributable to the grant of a restrictive covenant.

A.3 Exceptions to the Income Inclusion Rule – Arm's Length Requirement *(s. 56.4(3))*

The elective provisions in proposed subsection 56.4(3) only apply to restrictive covenants granted to arm's length persons. Consequently, relief will not be available under this subsection in two common situations. The first is a sale of shares of a corporation where, under paragraph 251(5)(b), the vendor and purchaser are deemed not to deal at arm's length simply by virtue of the share purchase agreement itself. The second situation is where a vendor corporation sells assets by transferring them to a wholly-owned subsidiary followed by a sale of the shares of that subsidiary to an arm's length purchaser. Paragraph 56.4(3)(b) will not apply with respect to a restrictive covenant granted by the vendor corporation in connection with the transfer of the assets to the subsidiary, even though the overall transaction is clearly arm's length. Denial of the election in these circumstances seems inappropriate in tax policy terms.

Recommendation:

We recommend that proposed subsection 56.4(3) be modified so that it applies in the circumstances described above.

A.4 Proposed Limitations on the Application of s. 68 are too Narrow *(s. 56.4(5), (6), (7), (8))*

The proposed limitations on the application of section 68 as set out in subsections 56.4(5) to 56.4(8) are too narrow. For example, the exception in subsection 56.4(7) requires that the covenant be a non-competition covenant granted for no consideration to a person with whom the grantor deals at arm's length, and further requires that the amount in question be included in computing a "goodwill amount" by the grantor, or received or receivable by a corporation that was an "eligible corporation" of the grantor and included in its goodwill amount. The definition of “eligible corporation” means that, for example, this provision will not apply where there are two shareholders of the company selling the business in question. Indeed, it appears that it also will not apply where the vendor has a holding company, because in that case the vendor will not "hold" shares of the vendor corporation – his or her holding company will. (We note that this unnecessarily narrow definition of eligible corporation also is relevant to proposed subsection 56.4(2).)

Recommendation

We recommend that the proposed limitations in subsection 56.4(5) to 56.4(8) be reconsidered to ensure section 68 does not apply too broadly to normal commercial arrangements for which the income tax treatment is currently appropriate.

B. Trusts

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

We note the changes that have been made to the definition of “testamentary trust” in the 2005 Proposals. However, we still have a concern with respect to the time limit in clause (d)(iii)(C) of the definition for applying to the Minister for approval for the exception in that clause to apply to payments made more than 12 months after death. It seems overly restrictive to require the application to the Minister to be made within 12 months after death. There could be situations where it is not anticipated in the first 12 months that amounts will have to be paid after that time on behalf of an estate.

In addition, the coming-into-force for this clause seems to contain a problem. For taxation years ending before the enacting bill receives royal assent, it appears that the 12-month period for excluded payments starts from royal assent. This is because, with the change made by the coming-into-force provision, the relevant part of the clause will read: "that payment was made within the first 12 months after the day on which the [name of amending act] is assented to." We suspect that what is intended is that payments be excluded if they are made in an extended period -- from the date of death to 12 months after royal assent.

Recommendation:

We recommend that the application to the Minister for the purpose of proposed clause (d)(iii)(C) of the definition of "testamentary trust" in subsection 108(1) not be subject to a time limitation. For consistency, we recommend that the time limit for application be removed from clause (d)(iii)(B) as well. In addition, the coming-into-force with respect to proposed clause (d)(iii)(C) should be changed so that it provides that the reference to "within the first 12 months after the individual's death" be read as a reference to "after the individual's death and no later than 12 months after the day on which the *Income Tax Amendments Act, 2005* is assented to".

B.2 Loss of Testamentary Trust Status
(s.249(6))

Proposed paragraph 249(6)(d) contains a rule relating to the determination of the fiscal period of a trust or estate after it loses its status as a testamentary trust. It is not apparent to us why this rule refers to the fiscal period of the trust or estate, since fiscal period is generally defined with respect to a business or property. What appears to be meant is the fiscal period for a business or property of the trust or estate, as is referred to in proposed paragraph 249(6)(a), so that paragraph 249(6)(d) operates as a companion rule to paragraph 249(6)(a).

Recommendation:

We recommend that proposed paragraph 249(6)(d) be modified to address the above concern.

C. Charities and Gifts

C.1 Non-Arm's Length Transactions
(s.248(36))

Proposed subsection 248(36) appears to apply with respect to the previous owners of a property who were non-arm's length at the time that the donor makes the gift to the charity. There can be circumstances in which the non-arm's length relationship may be present when the gift is made, but not at the time of the earlier acquisition.

Recommendation:

We recommend that the phrase "does not deal at arm's length" be changed to read "did not deal at arm's length at the time of the acquisition".

C.2 Deemed Fair Market Value Rules
(*s.248(35)(b))*

In proposed paragraph 248(35)(b) there is an exception for a gift made as a consequence of a taxpayer's death. However, there is no exception for property received by a donor on the death of another taxpayer. It seems inappropriate to limit the fair market value of such property to its cost to the donor. It will be necessary to value the property at the date of death (except where the spousal rollover applies), so the government should have no concern with the fair market value also being determined at the date of the gift.

Recommendation:

We recommend that the words "or the taxpayer acquired the property as a consequence of the death of another person" be added after the word "death" in the first line of proposed paragraph 248(35)(b).

C.3 Exception to Deemed Fair Market Value Rules
(s.248(37)(e))

Proposed subsection 248(37) provides a list of property that can be gifted without proposed subsection 248(35) applying. Cash is not included in that list. Therefore, in determining if a share that has been issued for cash, or for cash and other property, is described in paragraph 248(37)(e), it is not clear whether the condition in subparagraph 248(37)(e)(iii) is satisified. This is because it cannot be said categorically that subsection 248(35) would not have applied to a gift of cash even though, if it were applied to a gift of cash, it would not reduce the amount of the gift.

Recommendation:

We recommend that the words "to reduce the fair market value of the property" be inserted after the word "applied" in proposed subparagraph 248(37)(e)(iii).

C.4 Substantive Gift
(*s.248(39))*

Proposed subsection 248(39) applies to dispositions of property other than gifts. However, this is not clear from the opening words.

Recommendation:

We recommend that it be clarified in the opening words that this subsection is limited to dispositions of property other than gifts.

D. Other Comments

D.1 Limited-Recourse Debt
(*s.143.2(6.1)(c))*

Proposed paragraph 143.2(6.1)(c) includes in the "limited-recourse debt" in respect of a gift or monetary contribution of a taxpayer any debt that is not a limited-recourse amount if it is owing by the taxpayer, a non-arm's length person or an interest holder in the taxpayer and relates to the gift or contribution "if there is a guarantee, security or similar indemnity or covenant in respect of that or any other indebtedness". The closing language appears to be overly broad in two respects.

Firstly, there is no exclusion if the security is in fact granted by the debtor (as opposed to being in favour of the debtor) or other person described in paragraph (a) or (b). There is no reason that a gift or contribution funded by way of a secured debt should be treated as limited-recourse debt.

Secondly, the words “any other indebtedness” at the end of paragraph (c) seem to refer to any indebtedness whatsoever. This does not make sense to us. Presumably, it was intended that only other indebtedness of the sort described in the paragraph is to be considered, i.e. indebtedness of any taxpayer referred to in paragraph (a) or (b) that can reasonably be considered to relate to the gift or monetary contribution.

Recommendation:

In order to address the first concern we recommend that there be an express exclusion for security granted by the debtor.

In order to address our second concern we recommend that it be clarified that the reference to “any other indebtedness” is to the sort described in the paragraph.