THE CANADIAN BAR ASSOCIATION
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November 2, 2007

The Honourable Jim Flaherty, P.C., M.P.
Minister of Finance
L'Esplanade Laurier, East Tower
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Minister:

Re: 2007 Federal Budget – Excess Business Holdings Rules

I write on behalf of the Charities and the Not-for-Profit Law Section of the Canadian Bar Association (CBA Section) regarding the October 2, 2007 Draft Legislation and Explanatory Notes, in which the Budget 2007 tax measures, including the proposals dealing with excess business holdings, are contained. We are encouraged by the extension of tax relief for donations of marketable securities to private foundations. We do not, however, see the need for the extensive and complex excess business holdings rules which have been drafted by the Department of Finance. We wrote to Mr. Bob Hamilton, Senior Assistant Deputy Minister of Finance, about this matter on June 20, 2007. We elaborate upon the submissions made in that letter below.

Publicly Listed Shares

In our June 2007 letter, we suggested that there may be legitimate concerns about "self dealing" in relation to transfers of public shares to private foundations. Upon further reflection, however, there are instances where application of the excess business holdings rules even to transfers of public shares is problematic, such as a transfer of the shares of a longstanding family controlled public company to the family's private foundation. Given existing provincial and territorial legislation regulating the transfer of public shares to ensure public protection, the application of the rules to publicly listed shares should also be reconsidered.

Legislation regulating securities exists in most countries across the world. Canada has extensive provincial and territorial securities legislation applicable to shares listed and traded on public stock exchanges. Under this legislation, any person with direct or indirect beneficial ownership of voting securities with more than 10 per cent of all voting rights of a public company's securities is an insider and must report all transactions (including those with related parties). In addition, any person who has "control or direction" over more than 10 per cent of those voting

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securities is also an insider and has comparable reporting obligations. Certain transactions may be completely proscribed for insiders and related persons. For example, if an insider is privy to "inside information" that has not been generally disclosed, the insider would be prohibited from trading.

Public companies are also subject to a continuous disclosure regime under applicable securities laws. Under this regime, the issuer itself is obligated to disclose (in information circulars) any person or company who, to the knowledge of the issuer's directors or executive officers, beneficially owns (directly or indirectly), controls or directs voting securities carrying 10 per cent of the voting rights attached to any class or voting securities of the company. It must provide the name of every such person or company and the approximate number and percentage of securities so owned, controlled or directed.

Last, special rules apply to dispositions or acquisitions by "control persons". A "control person" means:

- a person or company who holds a sufficient number of the voting rights attached to all outstanding voting securities of an issuer to affect materially the control of the issuer, and, if a person or company holds more than 20 per cent of the voting rights attached to all outstanding voting securities of an issuer, the person or company is deemed, in the absence of evidence to the contrary, to hold a sufficient number of the voting rights to affect materially the control of the issuer, or

- each person or company in a combination of persons or companies, acting in concert by virtue of an agreement, arrangement, commitment or understanding, which holds in total a sufficient number of the voting rights attached to all outstanding voting securities of an issuer to affect materially the control of the issuer, and, if a combination of persons or companies holds more than 20 per cent of the voting rights attached to all outstanding voting securities of an issuer, the combination of persons or companies is deemed, in the absence of evidence to the contrary, to hold a sufficient number of the voting rights to affect materially the control of the issuer.[1]

Reports which show trading activity by insiders (including control persons) are accessible to the public on www.sedi.com. The continuous disclosure materials, required to be issued by issuers (including information circulars), are publicly available on www.sedar.com.
All of this information is available to the Canada Revenue Agency – and can be accessed and reviewed by auditors of registered charities if there is any concern about activities of individuals or their foundations. The detail available is significant and appropriate. What is not appropriate is for regulation of private foundations to drive how individuals structure their public company shareholdings, particularly when full disclosure is available and any concerns can be addressed by reference to current regulatory regimes.

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[1] See, for example, subsection 1(1) of the *Securities Act,* R.S.O. 1990, c.S.5.

Private Company Shares

As we stated previously, we believe adequate rules are in place to deal with the ownership of shares of private companies by private foundations. These include the rules on acquisitions of control (ITA ss. 149.1(4)(c) and 149.1(12)(a)), payment of dividends (ITA ss. 188.1(3) and 149.1(12)(a)), non-qualified investments (ITA ss. 149.1(1) and 189) and donations of non-qualifying securities (ITA ss. 118.1(3), (18) and (19)).

There is no special tax incentive for donations of shares of private companies, and extending the excess business holdings rules to the shares of private companies seems unnecessary and misdirected. The existing rules will apply in scenarios which to date have been acceptable to the CRA and other regulators. Further study is required to ensure that the new rules, if necessary, do not inappropriately apply to legitimate structures.

If the objective of the proposals is to require a private foundation and non-arm's length persons to divest their combined shares to a level below 20%, in many instances the foundation will not be able to retain shares of private companies received as donations. This is due to the fact that a foundation is often the sole shareholder of a company. There will then be no alternative to winding up the company or trying to sell its shares. Selling the shares will be difficult in many cases and winding up the company will raise other issues. We note the exception in the rules for non-qualified investments where the company is wholly-owned by the foundation. We also note that the proposals in former Bill C-33 would exempt from the deemed valuation rules a gift of shares where the donor acquired the shares from treasury and controlled the company before the gift, if the property for which the shares were issued would not be subject to those valuation rules. This recognizes the role of private companies owned by registered charities, including private foundations. We submit there should be an exception from the excess business holdings rules for wholly-owned companies, if those rules are to apply at all to shares of private companies.

We foresee instances where the new proposals would prevent foundations from managing their donations in the most efficient manner, or receiving them altogether, in circumstances where the policy rationale of preventing "self dealing" does not appear to apply. The first instance relates to donations to a private foundation of all of a private company's shares as an alternative to the company donating its assets. Individuals often own real estate or portfolios of listed securities indirectly through private companies. The most straightforward way for a private foundation to acquire and retain assets owned by a donor indirectly is to receive a donation of shares of a private company that itself owns the assets. There is no tax loss to the government in permitting an indirect transfer of a portfolio of listed securities or real estate to a private foundation because, unlike where there is a direct donation of listed securities, the donor will realize any inherent capital gain.[2] However, under the existing rules, the gift will not be recognized if the shares are non-qualifying securities. The foundation will be subject to the rules dealing with non-qualified investments and the penalty tax based on dividends received. In these circumstances, there is no prospect of self-dealing by a donor when no person other than the foundation owns any shares of the company. Accordingly, there does not appear to be any policy rationale for preventing such

[2] This is unless an election is made under ITA section 118.1(6) to treat the gift as occurring at less than fair market value.

a transaction. If the concern is that a donor will "control" the company through the foundation or the company will own listed shares that would be caught by the new rules if owned directly, we suggest the government consider a more focused approach.

The second instance relates to a private foundation that wishes to form a wholly-owned corporation and receive its shares in exchange for assets, such as donated real estate or a portfolio of listed securities. There are often business and commercial reasons (such as limited liability) for a private foundation to hold an asset indirectly. The existing rules dealing with acquisition of control are also relevant. If a private foundation transfers assets for no consideration to a company of which the foundation did not acquire control, other issues arise. Again, the proposals would prevent a private foundation from holding all the shares of this private company when no "self-dealing" concerns exist in the circumstances.

In conclusion, we see no policy reason for a private foundation that owns all of the shares of a private company to be considered to be "self-dealing" in the sense contemplated by the policy behind the excess business holdings rules. We strongly recommend that the excess business holdings rules not apply to shares of private companies at all. In the alternative, they should apply only in defined circumstances in which some specific type of potential abuse is possible, and not where the foundation is the sole shareholder.

Grandparenting

The CBA Section is concerned that the rules will apply to private foundations whose investments and structures were implemented in full compliance with the terms of the *Income Tax Act* (ITA) with no problems concerning self-dealing or non-compliance with the governing provincial and federal regulations. To force philanthropic families to restructure in ways which potentially harm not only the commercial activity, but also the foundation, is inappropriate and unfair.

If the government finds it necessary to enact rules limiting ownership in public and private companies, we strongly recommend that grandparenting rules be added to ensure that the new rules not apply to shares owned by, or governed by an enforceable agreement under which they could be acquired by, a private foundation on March 19, 2007. We submit that it is not appropriate to penalize private foundations that had arrangements in place with no expectation that the new regime might limit their ability to retain such shares.

The requirements are particularly onerous where private foundations hold more than 2% but less than 20% of the shares of any one class of shares (public or private) subject to a direction that the shares be held in perpetuity. The "entrusted share percentage" rules do not appear to adequately provide relief in these circumstances, with the result that the related persons may be forced to sell interests that are long standing family investments and give up control positions in private and public companies. All existing arrangements should be grandfathered and only be subject to the new rules if additional donations are made of the same class of shares or the CRA finds evidence of self dealing and imposes an intermediate sanction against the private foundation for such activity.

Non-arm's length concept

We are concerned about the concept of non-arm's length as it will apply to registered charities, including private foundations, who own shares of corporations, whether listed or private. The budget material states that a non-arm's length person will include a person that "controls" the foundation. This is the same concept that was introduced in former Bill C-33 dealing with the designation of charities and raises similar problems. "Control" is a concept that is very difficult to apply to a registered charity, whether it is a private foundation or otherwise. We assume that the extended concept of "control" contemplated in the definitions of public foundation and charitable organization, namely the same one as in ITA subsection 256(5.1) ("controlled, directly or indirectly in any manner whatever"), will be used.

Looking at the concept of "non-arm's length" itself, it is a question of fact under ITA subsection 251(1) whether persons not related to each other deal with each other at arm's length. Since a private foundation cannot be "related" to any person under the current definition, it will always be a question of fact whether a private foundation deals at arm's length with another person. We submit that the concept of "arm's length" is sufficiently difficult to address and introducing the concept of deemed control for this purpose will cause confusion and add another level of complexity that is unnecessary.

We trust that these comments will be of value in reviewing the draft legislation.

Yours truly,

(*Original signed by Susan Manwaring*)

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cc. Gérard Lalonde Director, Tax Legislation Division
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