Comité mixte sur la fiscalité
de l'Association du Barreau canadien
et
de l'Institut Canadien des Comptables Agréés

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Le 17 septembre 2010

Monsieur Brian Ernewein
Directeur général, Division de la législation de l'impôt
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Ministère des Finances
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Objet : Avant-projet de loi du 16 juillet 2010 concernant des modifications techniques de l'impôt sur le revenu

Monsieur,

Vous trouverez ci-joint notre mémoire portant sur les propositions législatives visant à mettre en œuvre des mesures en suspens concernant l'impôt sur le revenu. Nous sommes reconnaissants de la possibilité qui nous est donnée de commenter ces propositions.

Dans notre mémoire, nous commentons les propositions suivantes :

- modifications des alinéas 52(3)a), 53(1)b) et 89(1)a);
- article 56.4 et modifications connexes concernant les clauses restrictives;
- paragraphe 99(1);
- modifications de l'alinéa 110(1)k);
- modifications de la définition «fiducie testamentaire» et modifications connexes;
- article 143.3.

Le Comité mixte est conscient que les propositions législatives du 16 juillet 2010 comprennent plusieurs modifications reflétant diverses «lettres d'intention» publiées par le ministère des Finances au cours des dernières années, et que les contribuables visés s'attendent, avec raison, à ce que la *Loi de l'impôt sur le revenu* soit modifiée sans plus tarder pour donner effet à ces lettres. Nous exhortons donc le ministère des Finances et le Parlement à apporter ces modifications sans plus tarder.

Parallèlement, le Comité mixte a encore de sérieuses réserves concernant les règles relatives aux clauses restrictives. Dans nos mémoires antérieurs traitant de ces dispositions (datés du 20 décembre 2004 et du 30 janvier 2006), comme dans le mémoire ci-joint, nous soulevons un certain nombre de questions au sujet de l'application technique et pratique de ces règles.

Dans nos mémoires antérieurs, nous avons exprimé certaines préoccupations d'ordre général, que le Comité mixte trouvait alors très importantes, ainsi que des commentaires sur certains points techniques en particulier. Lors de discussions récentes avec des représentants de votre ministère, on nous a indiqué que plusieurs de ces points avaient été résolus depuis l'annonce initiale des règles, et nous sommes d'accord avec cette affirmation. Néanmoins, après avoir tenté de mettre en pratique les dispositions proposées pendant quelques années, nous tenons à souligner que nos préoccupations générales concernant l'application indûment généralisée des règles, leur degré de complexité et les difficultés inhérentes à leur application pratique, ont toutes été confirmées et qu'elles n'ont toujours pas été résolues.

Selon des études et des enquêtes, au cours des prochaines années, les entreprises canadiennes changeront de propriétaires comme jamais auparavant, et ce, en raison du vieillissement de la population. Nous pensons que l'application de ces règles, dans leur libellé actuel, nécessiterait l'affectation de ressources de temps et d'argent démesurées, tant par les contribuables que par l'Agence du revenu du Canada. Nous craignons également qu'elles donnent lieu à des incidences fiscales inappropriées, comme le traitement des rentrées de capital à titre de revenu, ou encore la double imposition des montants reçus par les sociétés lorsqu'aucun allégement fiscal n'est prévu par la loi. Cette situation est inquiétante, alors que nous croyons qu'il est possible d'élaborer un ensemble de règles qui répondent, d'une part, aux préoccupations du ministère des Finances au sujet de la planification fiscale de certains contribuables, préoccupations qui sont à l'origine des modifications proposées, et, d'autre part, au besoin d'équité et de certitude à l'égard de l'ensemble des contribuables.

Nous appuyons les commentaires récents du ministre des Finances sur la réduction de la paperasserie dans la mesure du possible. Le 9 septembre, alors qu'il parlait des modifications apportées récemment aux règles concernant les biens canadiens imposables, le ministre a mentionné que «le meilleur moyen de rendre l'économie plus compétitive consiste à créer un milieu d'affaires où les entrepreneurs qui emploient un si grand nombre de Canadiennes et de Canadiens peuvent réussir et étendre leurs activités, et non pas un milieu qui fait obstacle à leur réussite en raison d'impôts élevés et de paperasserie inutile». Nous félicitons le ministère des Finances pour l'assouplissement des règles relatives aux biens canadiens imposables; nous déplorons toutefois le fait que les mesures législatives proposées relativement aux clauses restrictives accroîtront la complexité de certaines opérations commerciales et la paperasserie pour des opérations courantes.

Nous recommandons vivement au ministère de revoir la portée des règles relatives aux clauses restrictives. À cet égard, nous suggérons de retirer les modifications qui concernent ces règles de l'ensemble des modifications actuellement proposées pour en permettre une analyse plus poussée, sans pour autant retarder davantage l'entrée en vigueur des modifications liées aux «lettres d'intention». Nous savons que des membres de notre comité et d'autres représentants du secteur privé accepteraient de continuer de chercher, en concertation avec votre ministère, une solution législative simplifiée aux questions qui préoccupent le ministère et les contribuables.

Nous serions par ailleurs heureux de vous rencontrer, au moment que vous jugerez opportun, pour discuter de notre mémoire.

Veuillez agréer, Monsieur, nos salutations distinguées.

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Submission of the Joint Committee on Taxation
of The Canadian Bar Association and The Canadian Institute of Chartered Accountants
regarding the July 16, 2010 Draft Legislation

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1. Paragraphs 52(3)(a), 53(1)(b) and 89(1)(a)

Proposed paragraph 52(3)(a) reduces the cost of shares received as a stock dividend to the extent that the amount of the stock dividend was deductible to the recipient corporation under subsection 112(1), except any portion of such stock dividend that is not subject to subsection 55(2) because it is attributable to the paying corporation's "safe income."

Similarly, paragraph 53(1)(b) proposes to limit the increase in the cost base of shares of a class in respect of which there has been an increase in paid-up capital to exclude the portion of the deemed dividend arising pursuant to subsection 84(1) which is deductible to the corporate shareholder under subsection 112(1), except to the extent the deemed dividend is not subject to subsection 55(2) because it is attributable to the paying corporation's "safe income".

The proposed provisions differ from the prior proposed amendments to paragraphs 52(3)(a) and 53(1)(b) (as set out in former Bill C-33, November 2006) in two respects: (i) the "grind" of cost base pursuant to both provisions has been limited so as not to apply to dividends which would not be subject to subsection 55(2) because the capital gain referred to in that subsection could reasonably be considered not to be attributable to anything other than "safe income", and (ii) the limitation in paragraph 53(1)(b) applies to all increases in paid-up capital that result in a deemed dividend pursuant to subsection 84(1) (instead of only those deemed dividends that arise from a conversion of contributed surplus).

We acknowledge that the changes described in (i) above will now facilitate the implementation of certain routine safe income crystallisation transactions. However, these revisions and the Explanatory Notes do not shed light on the transactions that Finance regards as abusive, and the provisions continue to apply to a number of legitimate commercial transactions.

As noted in our March 7, 2007 submission concerning these proposed amendments, we understand the impetus for these changes is to prevent tax free inter-corporate dividends from permitting a reduction in a capital gain. Generally, the anti-avoidance rule in subsection 55(2) applies to reductions of capital gains associated with the payment of inter-corporate tax free dividends. It is not clear why dividends (or deemed dividends) that are not subject to subsection 55(2) because of the application of paragraph 55(3)(a) or (b), or because the dividend is subject to unrefunded Part IV tax, would result in a limit on an increase in cost base under proposed paragraphs 52(3)(a) and 53(1)(b). To the extent that section 55 permits corporate surplus to reduce a capital gain, amendments to other provisions in the Act which purport to deny this reduction create uncertainty regarding the underlying legislative policy of these provisions. Thus we reiterate the recommendation made in our March 7, 2007 submission that any perceived deficiencies in section 55 should be addressed by targeted amendments to section 55.

Moreover, proposed amendments to the definition of "capital dividend account" have the effect of excluding from the computation of a corporation's capital dividend account the portion of the corporation's capital gain or capital loss that results from the "grind" in proposed subparagraphs 52(3)(a)(ii) and 53(1)(b)(ii). Under proposed paragraph 89(1)(a), for CDA purposes only, the corporation's gain or loss is calculated as if the adjusted cost base of the shares was not reduced by the deductible portion of a stock dividend or the deductible portion of a deemed dividend pursuant to subsection 84(1). Thus, the non-taxable portion of the gain that is included in the corporation's CDA is less than the non-taxable portion of the capital gain actually realised by the corporation, after taking into account the application of proposed subparagraphs 52(3)(a) and 53(1)(b).

To the extent that a dividend is not re-characterised as a capital gain under subsection 55(2) in the hands of a corporate shareholder, and an increase in cost base is not recognised under proposed paragraphs 52(3)(a) or 53(1)(b), we are unable to discern the policy rationale that would justify the loss of integration resulting from the exclusion of any part of the non-taxable portion of a capital gain from the corporate shareholder's capital dividend account. We submit that a parallel computation should be used for computing a corporation's capital gain and the amount added to its CDA in respect of the same disposition.

Finally we note that the proposed amendments are intended to be effective as of November 9, 2006. The July 16, 2010 proposals broaden the application of proposed paragraph 53(1)(b) to all deemed dividends resulting from the application of subsection 84(1). Taxpayers who completed transactions in reliance on the former version of proposed paragraph 53(1)(b) (as set out in Bill C-33) are required to elect to have the Bill C-33 version of paragraph 53(1)(b) apply to any dividend that was received after November 9, 2006 and before July 16, 2010. The Canada Revenue Agency has a long standing policy of encouraging taxpayers to file on the basis of proposed legislation. We suggest that it is inappropriate to impose additional compliance obligations on taxpayers in respect of transactions that have been completed and reported in accordance with draft legislation, in order for the expected tax treatment provided under the former draft amendments to be preserved. The election mechanism should be changed to require an election from taxpayers who wish to rely on the new version of paragraph 53(1)(b) contained in the July 16, 2010 proposals in respect of dividends received prior to July 16, 2010.

Recommendation:

We believe that the proposed rules should not apply in any situation where subsection 55(2) does not apply to the dividend. Consequently, if transactions involving dividends are escaping taxation under conditions that the Department of Finance considers abusive, we recommend that section 55 be amended to address those specific concerns (as it has in the past) as opposed to enacting new rules that are not coordinated with section 55.

We also recommend that taxpayers wishing to benefit from the new version of paragraph 53(1)(b) for dividends received after November 9, 2006 and before July 16, 2010 be permitted to elect in writing to have the new version of paragraph 53(1)(b) apply to their prior transactions.

2. Section 56.4 and related amendments

a. General Impact of the Rules

As has been stated in our previous submissions, we believe that the proposed definition of a restrictive covenant and accompanying rules are too broad and could apply to a wide range of commercial contracts where the tax treatment under existing provisions is appropriate. In particular, 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. The rules are also too complex as currently drafted and cannot be practically applied in many situations.

Although the Department of Finance has introduced exceptions to deal with some of the specific problems identified by the Joint Committee and others, the complexity of these legislative remedies shows that the scope of the rules was too broad to begin with. Also, as various commercial transactions are entered into, it is becoming clear that any group of specific exceptions will not be sufficient to ensure that bona fide commercial transactions are not subject to adverse tax consequences.

We understand that the Department of Finance has tax avoidance concerns related to:

1. Non-taxable receipts - Planning undertaken by taxpayers (such as in the *Manrell* case) where values were assigned specifically to non-competition payments and other covenants to escape taxation.
2. Conversion of income to capital - Planning undertaken to change the nature of what would have ordinarily been income into a capital transaction.
3. Value shifting - If the value of covenants is not separately identified and allocated to the person who granted the covenants, their value could be taxed in the hands of a lower income taxpayer, resulting in a loss of tax revenue.

As a response, the Joint Committee believes that it is possible to create draft proposals that will address the first two concerns that would be more directed and significantly less complicated. In terms of the third concern, we believe that the risk of a revenue loss is not significant as non-arm's length members of a business will generally have enough income without the value of a covenant to fully utilise low personal tax rates and credits. Consequently, the aspects of the proposed rules that attribute the value of a covenant away from the actual recipient of consideration to the grantor will not result in a material increase in tax revenue while they will result in a significant increase in compliance costs and adverse tax consequences.

Recommendation:

We believe that the proposed change to section 68 should be withdrawn in its current form. This would allow proposed section 56.4 to be significantly simplified. That said, section 56.4 could be made effective to deal with the receipt of specific consideration for covenants so that these amounts do not escape taxation.

To address the inappropriate conversion of income amounts into capital (which we understand was the rationale for the proposed change to section 68), specific anti-avoidance rules could be used to ensure income amounts are taxed as ordinary income even if mixed with proceeds for other property. This would ensure that the tax treatment for non-controversial transactions will not be altered by the current proposals and additional compliance costs will not have to be expended to comply with the rules.

We believe that much of the underlying complexity of some of the exceptions in subsection 56.4 is due to the Department's "value-shifting" concern. Therefore, we believe that the rules could be simplified without causing significant issues in terms of a loss of tax revenue.

As an overall recommendation, we suggest that consultations with stakeholders be continued to identify other alternatives that could significantly simplify these rules while ensuring that key policy concerns are addressed.

b. Specific issues associated with the July 16, 2010 Draft Legislation

The Joint Committee has identified a number of specific technical concerns with the rules in previous submissions. We also recognize that the Department of Finance has responded to several of the issues with further legislative changes. Although these revisions did address specific problems for specific transactions, they were not simple solutions in some cases (which has added to the complexity of the rules) and some of the solutions will only be useful in very specific situations. The Joint Committee believes that this exercise of problem identification and response by way of complex legislative exceptions underscores our view that the rules are overreaching and that the concept of deemed income treatment as a starting point will result in adverse tax consequences unless numerous additional exceptions are created. As indicated, the Joint Committee believes that proceeding by way of additional exceptions is a less than satisfactory solution, in view of the inherent limitations that will condition their application, and the additional complexity they will inevitably create.

In this section of the submission, we have highlighted some of the key issues that have been previously identified. We reiterate that while it is important to note these issues, the Joint Committee believes that making general changes to the legislation is the only way to eliminate the problems identified on a more universal basis.

i. Draft rules should not apply to capital amounts that are otherwise subject to tax

Practical experience thus far under the draft rules clearly suggests that the covenants included in purchase and sale agreements will be the most problematic covenants to deal with under the proposed rules. At the same time, these covenants should be the least objectionable in terms of tax policy as long as the value of the covenant is subject to tax. In the context of a purchase and sale agreement, the purpose of the covenant is generally to protect the value of an enduring asset on its transfer to a new owner. For example, if a service provider sells their business, including a list of clients, the value of the client list is greatly diminished if the agreement does not include rules prohibiting competition by the vendor. A non-competition agreement or other covenants in these agreements will be capital receipts in the vast majority of cases.

We reiterate that the value of the covenant in these situations cannot escape taxation if its value has been effectively combined with the value of a tangible asset where the proceeds from that asset are subject to tax. In the *Manrell* case and other similar situations, the parties attempted to separate the value of the covenant so that it escaped taxation. Therefore, we do not understand why taxpayers who are not undertaking "Manrell-like" planning will be forced to value each covenant, assume that a receipt in respect thereof will be income, and then determine if one of a number of complex exceptions can apply. If an exception does not apply, then an inappropriate tax result will arise.

Recommendation:

The proposed changes to section 68 should be abandoned and replaced by a specific anti-avoidance rule to deal with the conversion of income amounts into capital. For amounts that are clearly capital receipts, such a rule would make negotiating purchase and sale agreements more straightforward, greatly simplify the tax compliance in respect of the sale and prevent inappropriate results.

ii. Determining the value of a covenant is problematic

The proposed changes to section 68 and several of the rules in proposed section 56.4 assume that it is actually possible to establish the value of a covenant where that covenant is an integral part of a larger transaction. The classic example is the sale of business assets or shares of a business entity where the terms and conditions include a non-compete covenant. The reality in many transactions, many of which involve small and medium-sized businesses, is that the covenant is integral, in that the transaction will not occur if the covenant is not included. As covenants are deemed to give rise to income, this may produce an onus on the taxpayer to value the covenant (depending on what exception is being applied). For example, many common transactions will rely on subsection 56.4(9) to ensure capital amounts continue to be taxed as capital; that subsection requires a specific value for the covenant.

In the Joint Committee's December 20, 2004 submission, it was suggested that many taxpayers are being forced to participate in a fiction due to these rules. That is an extraordinary statement, but reflects the reality that there is no practical method available to value many covenants and, in certain cases, taxpayers intending to comply are forced to guess at a value for the relevant covenant. A more practical basis for the application of taxing provisions must exist for taxpayers to be in a position to comply when filing a tax return.

A leading case on determining value[1] for tax purposes suggests that "fair market value" is the highest price available estimated in terms of money which a willing seller may obtain for the property in an open and unrestricted market from a willing, knowledgeable purchaser acting at arm's length. Where a restrictive covenant is integral to a transaction, it is typically the case that the asset and the covenant may not be economically separable, in that there would be no willing buyer for the asset without the covenant or for the covenant without the asset. This is the fundamental problem in many situations; it is not merely an issue of taxpayers complaining that it is inconvenient (but possible) to separately value the covenant in question.

Where a value cannot be established with acceptable certainty, the grantor of the covenant is left in the position of not being able to comply with these proposed rules in an acceptable manner.

Recommendation:

We submit that it is possible to introduce simpler rules that will determine whether it is necessary to separately value a restrictive covenant. Our recommendation to withdraw the proposed changes to section 68 and adopt a specific anti-avoidance provision will ensure that covenants only have to be valued where inappropriate tax results would arise absent such a separate valuation. We suggest that

[1] *Re Mann Estate*, *1972+ 5 W.W.R. 23 (BCSC), aff'd *1973+ 1 C.T.C. 561 (BCCA), *1974+ C.T.C. 222 (SCC)

as long as the covenant is being subjected to tax, and an income receipt is not being converted into a capital receipt, there is no need to interfere with the application of the current provisions of the Act.

iii. Proposed limitations on application of section 68 are too narrow (s. 56.4(5), (6), (7), (8) and (8.1))

Although the Department of Finance has broadened the limitations on the application of proposed section 68, the proposed limitations set out in subsections 56.4(5) to 56.4(8.1) are too narrow and exceeding complex to apply. As an example, it appears that many transactions involving family-owned business corporations, which make up a significant portion of the Canadian economy, will generally not qualify for these exceptions. Instead, they must rely on a complicated capital gain rule in subsection 56.4(9) which appears to be dependent on determining a value for the covenants given by family members so that amounts can then be extracted from the corporation without double taxation.

Recommendation:

The suggested change to replace section 68 with a specific anti-avoidance rule will address this issue in most situations. Again, if the proposed changes are directed at perceived problems, then there will not be a need for extensive and complicated exceptions.

iv. Elective relieving provisions are effectively not available where CRA applies proposed section 68

As discussed above, valuing a covenant will be at best problematic and in many situations, not possible. Therefore, there will be at least some risk in virtually all transactions that the CRA will not agree with a value determined by a taxpayer for a covenant. Also, where a taxpayer has not realized that he was expected to deal with a covenant as a separate amount, the CRA may apply section 68 to separate the covenant value. In either case, any relieving provision that requires a time-limited election will most likely not be available (paragraphs 56.4(3)(b) and (c) in particular as well as subsection 56.4(9)) as the time for electing will have passed. Consequently, it appears that a taxable capital amount will be subject to deemed income treatment on a CRA reassessment. Also, the relief under subsection 56.4(9) is dependent on taking specific action within 180 days that goes beyond making an election.

Even though the CRA has not yet reassessed a taxpayer based on proposed section 68, this amendment has already caused significant issues in business transactions where the parties cannot agree on the value of a covenant. The lack of consensus on a value introduces the risk that what should be capital payments under basic principles will become taxable as income due to the inability to access an exception that would have otherwise been available if an agreement could be reached on value.

Recommendation:

Rather than trying to deal with this concern specifically, we suggest the best way to address this issue is to limit the scope of proposed section 68 as discussed earlier. Elective exceptions may not be needed. Also, if elections are required, it should also be possible to make a late election or take any action required at a later time in response to a CRA reassessment.

v. Proposed amendments may tax more than one party to the restrictive covenant (s. 56.4(2))

The proposed rule will tax the person providing the covenant, even where the amounts paid in respect of the covenant are received by another person. Where a vendor is a member of a corporate group, a covenant not to compete may not relate to a particular individual or group of individuals. Rather, the vendor may be covenanting that the corporate group of which it is a member will not compete with the purchaser.

The determination of which of these entities would be taxed under proposed subsection 56.4(2), and to what extent, is far from clear. In appropriate circumstances, provisions such as subsection 56(2) of the Act could be invoked to tax the "true" recipient. In this regard, we note that if an amount in respect of a restrictive covenant were included in the recipient's income under section 9, it could also be included in another taxpayer's income under proposed subsection 56.4(2). The proposed amendments do not appear to limit double taxation in these circumstances.

In addition, where a taxpayer has an income inclusion in respect of an amount received (or deemed to have been received) by a non-arm's length taxpayer, in many cases there will be further tax costs associated with transferring the cash amount actually received in the transaction from the recipient to the person charged with the tax (such as on a dividend from a corporation to its shareholder), which is a form of double taxation. There are exceptions to the application of proposed section 68, but these will not deal with all possible problems.

We note that a capital gain rule is available in subsection 56.4(9). However, this rule will not cover all appropriate circumstances due to the conditions that apply and is again based on the questionable assumption that the covenant can in fact be valued.

Recommendation:

We recommend that proposed subsection 56.4(2) be revised so as to clarify that an amount received in respect of a restrictive covenant is to be taxed in the hands of the recipient(s) of the payment and not in hands of the person providing the covenant. As a minimum, this recommendation should apply to corporations.

Our recommendation would allow for a significant simplification of the rules where an amount is received by a corporation. Assuming that the covenant is subject to tax and the nature of the receipt has not been changed from income to capital, there is no need to apply proposed subsection 56.4(2). Rather, the amount would be subject to tax in the corporation as a capital receipt, with the usual integration implications. Although this could mean that the value of the covenant could be shared as a dividend among shareholders that did not provide the covenant, we believe that any loss of tax revenue due to this will be minimal given that most taxpayers holding shares will have income before any additional dividends are distributed by the corporation out of consideration received by the corporation for the value of the covenant. If income otherwise exceeds lower tax rate brackets and personal credit limits, the after-tax value of the covenant will be subject to full taxation when paid to shareholders as a dividend.

vi. Tax-deferred transfers and section 56.4 exceptions

Draft section 56.4 continues to deny the relief that is provided by paragraph 56.4(3)(c) if a restrictive covenant is granted in connection with a disposition to a corporation or partnership that occurs on a tax-deferred basis (i.e., under a section 85 or subsection 97(2) rollover). Further, the relief provided under proposed subsection 56.4(5) from the application of section 68 is denied under proposed subsections 56.4(7), (8) and (8.1) if the disposition involves certain tax-deferred transfers under section 85 or subsection 97(2).

As noted in our January 30, 2006 submission, there is no obvious tax policy reason for the above-mentioned denial of relief. Indeed, denying relief from section 68 where a tax-deferred transfer is involved further increases the uncertainty as to the application of the Act to purchase and sale transactions.

To the extent that any non-share consideration is attributable to the restrictive covenant, it should be treated like other "boot". To the extent that share consideration is attributable to the restrictive covenant, the value of the share consideration should not be added to the proceeds of disposition as long as the covenant is capital in nature. The same comments apply with respect to a rollover to a partnership under subsection 97(2). If income is being inappropriately converted into capital and is then subject to a tax rollover, a specific anti-avoidance rule can deal with this possibility.

Recommendation:

We do not believe that there is any reason to subject covenants to more onerous rules, and potential inappropriate tax consequences, simply because a tax rollover is being used in a transaction. If the covenant is a capital asset, then it should qualify for a tax rollover in the same way as any other capital asset. If an income receipt is being converted into a capital amount, and therefore, becomes eligible for a rollover, specific anti-avoidance rules should be developed to deal with this problem.

3. Subsection 99(1)

Proposed subsection 99(1) is a deeming rule intended to accommodate the calculation of the adjusted cost base of a partnership interest where, at any particular time in a fiscal period of a partnership, the partnership has ceased to exist. Proposed subsection 99(1) is set out in section 50 of the draft enabling legislation, which does not provide any effective date for the amendment. The Explanatory Notes state that the amendment applies on Royal Assent. It is unclear whether subsection 99(1) is a declaratory provision or whether it is only intended to apply where the "particular time" set out in proposed subsection 99(1) occurs after Royal Assent. We note that detailed provisions have been included in the draft enabling legislation with respect to the application of proposed subsection 96(1.01), a similar deeming provision.

Recommendation:

We recommend that it be clarified in the enabling legislation that proposed subsection 99(1) is declaratory, or that this be clarified in the Explanatory Notes.

4. Paragraph (d) of the definition of "Testamentary Trust" – 108(1)

We understand that the purpose of paragraph (d), which excludes from the definition of "testamentary trust" trusts that have incurred indebtedness to a beneficiary or to a person that does not deal at arm's length with a beneficiary, is to preclude the use of testamentary trusts to achieve income splitting. However, proposed paragraph (d) may produce unintended results in common estate administration transactions that are not undertaken to achieve income splitting.

One of the significant consequences of the loss of testamentary trust status in the course of administration of an estate is that any capital loss incurred by the estate after its loss of status (which loss of status would result in a deemed year end pursuant to proposed subsection 249(6)) cannot be carried back to the deceased's final tax return under subsection 164(6) since that subsection only allows capital losses that are incurred during the first taxation year of the estate to be carried back**.** An example can best illustrate the issue:

> X controls Xco. X dies. The beneficiaries of X's estate are X's four children, A, B, C, and D. Children A and B are the executors. During the executors' year, Xco sells a property to the estate for a note, as the executors plan to distribute the property in question to a particular beneficiary.
>
> In this situation, Xco (controlled by A and B) does not deal at arm's length with A, B, C and D (subparagraph 251(2)(b)(iii)); thus, the estate would lose its status as a testamentary trust at the time the debt is incurred pursuant to proposed paragraph (d), and the trust would have a deemed year end pursuant to proposed subsection 249(6).

As a result of the application of these provisions, the capital loss that the estate would incur on the disposition of the shares of Xco (or on the disposition of another property) after that time would not be eligible for carry back. We suggest this result is inappropriate.

Other unintended consequences may arise from the loss of testamentary trust status pursuant to proposed paragraph 108(1)(d). For instance, in the factual example outlined above, if beneficiary D is a non-resident, the loss of testamentary trust status may cause the trust to be subject to Part XII.2 tax if the estate has designated income in the taxation year commencing after the subsection 249(6) deemed year end.

In this example, the purpose of the estate incurring the debt would not have been to income split but to effectively administer the estate and distribute assets. Moreover, it appears the loss of status would not occur in the above example if the executors (who control Xco) were dealing at arm's length with A, B, C and D.

We note that other anti-avoidance rules could apply (e.g. 15(2)) to address the income splitting concern. In the above example, the note would generally not be outstanding beyond the executor's year since the intention would be to settle the debt on the winding up of Xco (or on the redemption of the control shares held by the Estate if an estate freeze had occurred during X's lifetime) and because of the potential application of subsection 15(2).

Recommendation:

We recommend that the scope of proposed paragraph (d) of the definition of "testamentary trust" in subsection 108(1) be revisited to address these concerns. For example, perhaps loans or indebtedness from corporations controlled by an estate to the estate during the executors' year should be excluded from the application of the proposed amendment. Alternatively, we suggest that appropriate amendments be made to subsection 164(6) and Part XII.2 to avoid the unintended results that may arise from the loss of testamentary trust status pursuant to paragraph (d) of the definition of "testamentary trust" in subsection 108(1) (and the resulting deemed year end).

5. Implied combined federal and provincial income tax rates – paragraph 110(1)(k)

The proposed amendment to paragraph 110(1)(k) replaces the factor of 9/4^{ths} with:

- a factor of 3 for taxation year-ends before 2010,
- a factor of 3.2 for taxation year-ends in 2010 and 2011, and
- a factor of 3.5 for taxation year-ends in 2012 and subsequent years.

This amendment will apply to 2003 and subsequent taxation years. The table below illustrates the implied combined federal and provincial corporate income tax rate for each of the new proposed factors:

Taxation Year	Paragraph 110(l)(k) Factor	Implied Corporate Tax Rate
Pre-2003	9/4	44.44%
2003-2009	3	33.3%
2010	3.2	31.25%
2011	3.2	31.25%
2012	3.5	28.57%

Taxpayers who pay an actual combined corporate income tax rate below the implied tax rate will continue to face a tax cost despite these proposed amendments. Thus,

- for 2010 —corporate taxpayers in all provinces except Nova Scotia, Prince Edward Island and Newfoundland, where the 2010 combined federal and provincial general corporate income tax rate is more than 31.25%, will still face a tax cost despite the proposed amendment.

> For example, in 2010, an Ontario-based corporation (Ontarioco) paying $1,000 of Part VI.I tax would be entitled to a section 110(1)(k) gross-up of 3.2 times, giving rise to a deduction of $3,200. Based on Ontarioco's corporate tax rate of 31% in 2010, it would only realize Part I tax savings of $992 ($3,200 × 31%) for a net cost of $8 per $1,000 of Part VI.I tax paid.

- for 2011 —corporate taxpayers in all provinces, except Nova Scotia and Prince Edward Island, will still face a tax cost since their combined federal and provincial corporate income tax rates are below 31.25%.
- for 2012 — corporate taxpayers in all provinces except Nova Scotia, Prince Edward Island and Newfoundland will still face a tax cost since their combined federal and provincial corporate tax rates are below 28.6%.

We note that an amendment to paragraph 191.1(1)(a) is also proposed to reflect the reduction in the general corporate income tax rate, and that the Explanatory notes state that other provisions which assume a specific underlying corporate income tax rate will be reviewed.

Recommendation:

Provisions of the Act which assume a specific underlying corporate income tax rate should reflect the relevant provincial general corporate income tax rate. In this regard, we note the amendments that were made in 2008 to the definition of "taxable SIFT trust distributions" and the accompanying regulations, which effectively ensure the proper rate of tax is taken into consideration notwithstanding periodic changes in corporate income tax rates. We recommend that similar amendments be made to paragraph 110(1)(k).

6. Property acquired other than by way of "transfer" – 143.3(5)(e)

Proposed paragraph 143.3(5)(e) includes a clarifying provision for purposes of applying subparagraph 143.3(a)(ii). Paragraph 143.3(5)(e) confirms that the issuance of shares by a corporation in the context of a share exchange with the "issuing corporation" will be deemed to be a transfer of property.

While the proposed change is welcome, it does not extend to common situations other than share exchanges where the same interpretive concern underlying proposed paragraph 143.3(5)(e) may arise. In short, we continue to be concerned that there may be no "property transferred to" the corporation (for purposes of subparagraph 143.3(3)(a)(ii)) or to the taxpayer (for purposes of subparagraph 143.3(4)(a)(ii)) in these situations.

In particular, where an issuing corporation acquires (i) an interest in a partnership issued by the partnership, or (ii) an interest in a trust issued by the trust, as consideration for issuing a share of its capital stock, arguably the partnership or trust has not transferred property to the corporation as it has not divested itself of property that it owns.[2]

Similarly, taxpayers other than corporations that issue interests in themselves in consideration for a share, partnership interest, or interest in a trust acquired directly from the corporation, partnership or trust (respectively) may not be viewed as having received a transfer of property for the purpose of subparagraph 143.3(4)(a)(ii).[3] We note that the same uncertainty can arise where a party issues a promissory note or promise to pay to an entity in consideration for an interest in the entity.

Recommendation:

In order to address these concerns, we recommend that the words "property transferred to" in subparagraphs 143.3(3)(a)(ii) and (4)(a)(ii) be replaced by "property transferred or issued to".

7. Options to acquire shares – subsection 143.3(2)

As a consequence of subsection 143.3(2), a corporation will not have any cost for a property it receives as consideration for granting an option to acquire shares of its capital stock. As noted in our January 27, 2006 submission, this is not appropriate from a tax policy perspective since

(a) it results in asymmetrical treatment of taxpayers. The person disposing of property to the corporation for an option will have proceeds from the disposition of property equal to the fair market value of the option. The corporation should therefore have a cost in respect of the acquired property equal to this amount, not a cost of nil;

(b) if the option holder exercises the option, the consideration paid therefore will form part of the consideration paid for the shares (paragraph 49(3)(b)). The corporation should similarly have a cost in respect of the property acquired as consideration for granting the option as if that property had formed part of the consideration for the issuance of the shares. Conversely if the option expires, the corporation will realise a capital gain by virtue of subsection 49(2) equal to the proceeds received by it for granting the option. The amount of the gain will effectively be taxed twice if the property received by the corporation as consideration for granting the option has a cost of nil to the corporation pursuant to subsection 143.3(2).

We note that the same concern arises under paragraph 143.(3)(b) in that the corporation should be allowed to recognise cost in respect of a property acquired in consideration for the grant of an option.

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[2] *Algoa Trust et al. V. The Queen*, 93 DTC 405 (TCC)

[3] In the case of trusts, this result is suggested by the Canada Revenue Agency's interpretation of subsection 75(2) expressed in CRA docs. 2006-021850 (March 9, 2007) and 2007-0243241 (October 5, 2007), based on the November 1985 Department of Finance Technical Notes to subsection 75(2).

These concerns arise where the consideration given for the option takes another form, such as the provision of services (other than the specific situation described in subparagraph 143.5(a)) or where the "expenditure" in issue is an amount other than cost.

Finally, we note that the concerns expressed above apply equally in the case of a trust that has granted an option to acquire units of the trust to be issued by it. Neither subsection 143.3(2) nor paragraph 143.3(4) (b) should prevent the trust from recognising cost in property acquired as consideration for granting the option.

Recommendation:

We recommend that subsection 143.3(2) and paragraphs 143.3(b) and 143.4(b) be amended to address this concern.