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

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December 1, 2011

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

Re: October 31, 2011 Draft Legislation

Dear Mr. Ernewein,

It was a pleasure to have you and other members of your group meet with the Joint Committee at the Canadian Tax Foundation's Annual Conference in Montréal. As discussed during the meeting, we have identified concerns with two of the proposals included in the draft legislation released on October 31, 2011 and have enclosed our submission on these two proposals. As always, we greatly appreciate the opportunity to comment on the Department's legislative proposals.

Several members of the Joint Committee participated in discussions concerning this submission and contributed to its preparation, but in particular: Siobhan Monaghan and Mitch Sherman.

We trust you will find our comments helpful and would be pleased to meet with you to discuss this submission further at your convenience.

Yours very truly,

D. Bruce Ball
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Darcy D. Moch
Chair, Taxation Section
Canadian Bar Association

Submission of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants regarding the October 31, 2011 Legislative Proposals Relating to Income Tax

On October 31, 2011, the Department of Finance released for public comment draft legislation relating to a number of technical changes to the *Income Tax Act* (Canada) and other legislation (hereinafter the "Technical Amendments"). This letter includes the Joint Committee's initial comments on the Technical Amendments.

Proposed Paragraph 15(1.4)(c)

The Technical Amendments include a number of amendments to section 15. While some are stated to be clarifying or are intended to merely reorganize the provisions, the amendments also include substantive changes. In particular, new paragraph 15(1)(a.1) (coupled with an amendment to existing paragraph 15(1)(a)), and new paragraph 15(1.4)(c) are introduced. In our view, as drafted, the latter change will substantially broaden the application of subsection 15(1) and raises the possibility of multiple income inclusions for a single benefit.

Proposed paragraph 15(1.4)(c) will apply where a benefit is conferred on an individual[1] who does not deal at arm's length with, or is affiliated with, a shareholder of the corporation, a member of a partnership that is a shareholder of the corporation, or a contemplated shareholder of the corporation,[2] except to the extent that subsection 15(1) or 105(1) would apply to the individual in respect of the benefit if the Act were read without reference to paragraph 15(1.4)(c). Where it applies, the benefit conferred on the individual is deemed to be a benefit conferred on the shareholder, member or contemplated shareholder, as the case may be.

We have several concerns regarding proposed paragraph 15(1.4)(c). First, the jurisprudence suggests that existing subsection 15(1) should apply only where a benefit is conferred on a person *qua* shareholder: see for example, *Pillsbury Holdings Ltd.* v. *MNR* 64 DTC 5184 (Ex.Ct); *Pellizzari* v *MNR* 87 DTC 56 (TCC); and *Winter* v. *The Queen* 90 DTC 6681(FCA). We presume that the proposed amendments to section 15(1) are not intended to affect that principle. However, in our view, the amendments appear to do just that. Paragraph 15(1.4)(c) ***deems*** a benefit conferred on an individual by a corporation to be a benefit conferred on a shareholder of the corporation with whom the individual is affiliated or does not deal at arm's length.

Subsections 15(1) and 56(2) have been applied together to require a shareholder to include an amount in income under subsection 15(1) where the corporation has conferred a benefit on some other person pursuant to the direction of, or with the concurrence of the shareholder, for the shareholder's benefit or as a benefit that the shareholder desired to have conferred on the other person. While at first blush proposed paragraph 15(1.4)(c) might be viewed as simply codifying the combined application of subsections 56(2) and 15(1), it in fact goes much further. Proposed

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1 Other than a trust in which no individual (other than a trust) is beneficially interested.

2 As defined in proposed paragraph 15(1.4)(a).

paragraph 15(1.4)(c) does not require the shareholder to have played any role in the conferral of the benefit, or indeed to have any knowledge about the benefit; it does not even require the benefit to have been conferred on the individual because of the individual's relationship with the shareholder. This is in contrast to subsection 15(1) itself and to proposed paragraph 15(1.4)(a) which speaks of a benefit being conferred in contemplation of the person or partnership becoming a shareholder; the phrase "in contemplation of" means the proposed shareholding is to be taken into account: *OSFC Holdings Ltd.* v *The Queen* 2001 DTC 5471 (FCA). A link between the conferral of the benefit and the shareholding or contemplated shareholding is a requirement in both of these circumstances. A similar approach is taken in section 80.4. Proposed paragraph 15(1.4)(c) requires no link other than a conferral of a benefit on an individual affiliated, or not dealing at arm's length, with a shareholder (or a member of a partnership that is a shareholder) of the corporation conferring the benefit.

The exceptions for amounts included in the individual's income under subsections 15(1) or 105(1) are, in our view, too narrow. If the benefit is included in the income of the particular individual under any provision of the Act, subsection 15(1.4)(c) should not apply to deem the amount to be a benefit conferred on the shareholder. For example, where an individual who is affiliated with a shareholder is an employee of the corporation and, in that capacity, participates in the corporation's stock option plan or receives some other benefit governed by section 6, proposed paragraph 15(1.4)(c) should not apply to require the shareholder to include the benefit in income under subsection 15(1). The benefit under the stock option plan should be taxed under section 7 and not otherwise. The other benefits should be taxed under section 6 and not otherwise. Moreover, if a particular benefit is not included in the income of the individual because of a specific exemption (see, for example, subparagraphs 6(1)(a)(i) to (v)) or because it arises in the context of a particular business relationship (e.g., volume discount), it should not be included in the shareholder's income under subsection 15(1) through the application of proposed paragraph 15(1.4)(c).

As drafted, proposed paragraph 15(1.4)(c) could apply to require the benefit to be included in the income of more than one shareholder, in addition to the income of the individual who receives the benefit. This may be illustrated by the following example. Assume that Mr. X owns 1% of the common shares of Aco, a public corporation, and his wholly-owned investment corporation, Xco, owns 1% of a class of non-voting preferred shares of Aco. Mr. X's adult son, P, owns less than .05% of the Aco common shares. P's spouse is an account manager with Aco and, in that capacity, is granted options to acquire Aco shares under its stock option plan and is supplied with a car by Aco. Aco has granted benefits to P's wife, an individual, who is related to P, Mr. X and Xco, each a shareholder of Aco. Although P's wife will be taxed under section 7 if she exercises or disposes of the option and under section 6 in respect of the employer-supplied car, and does not enjoy those benefits because of her relationship with any shareholder, proposed paragraph 15(1.4)(c) applies to deem those benefits to be conferred on each of P, Mr. X and Xco: a benefit has been conferred on an individual who does not deal at arm's length with a shareholder of the corporation so the benefit is deemed to be conferred on the shareholder. Moreover, in addition to any income recognized by P's wife under section 6 or 7, it would appear each of P, Mr. X and Xco must include the full amount of the benefit in income. Subsection 248(28) would be of no assistance as it only applies where the amount is included multiple times in the income of a particular taxpayer.

Recommendation:

We recommend that proposed paragraph 15(1.4)(c) be abandoned on the basis that the circumstances in which it should apply are more than adequately covered by the joint operation of subsections 15(1) and 56(2).

Alternatively, proposed paragraph 15(1.4)(c) should be amended so that (i) it does not apply where the benefit is not conferred on the individual because of the individual's relationship with the shareholder, member or contemplated shareholder; (ii) it does not apply in any circumstance in which the benefit is, or but for an express exemption from tax would be, included in the individual's income under any provision of the Act; and (iii) where the provision does apply, and the individual is affiliated or does not deal at arm's length with more than one shareholder, the total benefit is allocated among the relevant shareholders in some way so that the benefit is taxed only once. For example, it might be allocated in proportion to their relative shareholdings (taking into account the shareholdings of a contemplated shareholder on the basis they were acquired immediately before the benefit is conferred).

Proposed Paragraph 115.2(2)(c)(ii)

The currently enacted version of subparagraph 115.2(2)(c) precludes a non-resident from benefiting from section 115.2 where the non-resident is a member of a partnership and partners that are affiliated with the Canadian service provider hold a greater than 25% interest in the partnership. The Technical Amendments propose to amend section 115.2(2)(c) with the objective of applying this 25% independence test at the partner level rather than the partnership level.[3] The Explanatory Notes that accompanied the Technical Amendments state that proposed subparagraph 115.2(2)(c)(ii) will apply to preclude a non-resident from benefiting from section 115.2 where the non-resident member:

> (a) is owned more than 25% by a person or partnership that is affiliated with the Canadian service provider ("an unqualified person"); or
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> (b) is, or is affiliated with, a person that is affiliated with the Canadian service provider, and

either alone or together with unqualified persons owns more than 25% of the partnership. Clause 115.2(2)(c)(ii)(A) is intended to correspond to (a) above and clause 115.2(2)(c)(ii)(B) is intended to correspond to (b) above.

However, as drafted, proposed paragraph 115.2(2)(c) denies the benefits of section 115.2 to a non-resident where the non-resident is affiliated with (rather than more than 25% owned by) a person or partnership described in clause 115.2(2)(c)(ii)(A) and the non-resident and persons or partnerships described in clauses 115.2(2)(c)(ii)(A) and (B) collectively own more than 25% of the partnership, notwithstanding that there is no affiliation between the Canadian service

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[3] This is consistent with comfort letters previously issued by the Department of Finance in June and November 2002.

provider and the non-resident. Consequently, proposed subparagraph 115.2(2)(c)(ii) will not achieve the stated legislative objective where the non-resident is itself affiliated with the partnership, and persons affiliated with the Canadian service provider own a greater than 25% interest in the partnership.

This is perhaps best illustrated by an example. Assume that a partnership (the "Partnership") has three partners. One partner ("CSPA") is a Canadian resident corporation that is owned by, and therefore affiliated with, the Canadian service provider. CSPA holds a 30% interest in the Partnership and is taxable on its share of the Partnership income. The second partner ("NRP"), a non-resident, holds a 55% interest in the Partnership. The third partner, a Canadian resident that deals at arm's length with each of CSPA and NRP, holds a 15% interest.

NRP is not affiliated with CSPA or the Canadian service provider and, but for its interest in the Partnership, would not be affiliated with a person or partnership described in clause 115.2(2)(c)(ii)(A) or (B) of the draft legislation. Nonetheless, based on the partners' respective ownership interests, NRP will not benefit from section 115.2 because

(i) it is affiliated with the Partnership: it is the majority-interest partner;

(ii) the Partnership is a partnership described in clause 115.2(2)(c)(ii)(A): CSPA, which is affiliated with the Canadian service provider, owns more than 25% of the interests in the Partnership and is not a designated entity in respect of the Canadian service provider; and

(iii) the fair market value of all investments in the Partnership is less than four times the total of the fair market value of investments in the Partnership held by CSPA, a person described in clause 115.2(2)(c)(ii)(B).

Proposed paragraph 115.2(2)(c)(iii) also applies to preclude NRP from benefiting from section 115.2: although NRP is not affiliated with the Canadian service provider or any person described in clause 115.2(2)(c)(ii)(B), as majority-interest partner it is affiliated with the Partnership which is a partnership described in clause 115.2(2)(c)(ii)(A).

Recommendation:

Revise proposed subparagraph 115.2(2)(c)(ii) to be consistent with the Explanatory Notes, so that it will apply to deny a non-resident the benefits of section 115.2 only where more than 25% of the interests in the non-resident are owned by persons or partnerships (other than a designated entity in respect of the Canadian service provider) that are affiliated with the Canadian service provider or where the non-resident is affiliated with the Canadian service provider.