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Le 15 octobre 2013

Monsieur Brian Ernewein
Directeur général, Division de la législation de l'impôt
Direction de la politique de l'impôt
Ministère des Finances
L'Esplanade, tour Est, 17e étage
140, rue O'Connor
Ottawa (Ontario) K1A 0G5

Monsieur,

Vous trouverez ci-joint notre mémoire sur l'avant-projet de loi que le ministère des Finances a publié le 13 septembre 2013.

Plusieurs membres du Comité mixte, ainsi que d'autres personnes, ont pris part aux discussions sur notre mémoire et ont contribué à sa rédaction, notamment :

K.A. Siobhan Monaghan (Davies Ward Philips & Vineberg S.E.N.C.R.L., s.r.l.)
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Edward Miller (Blakes S.E.N.C.R.L./s.r.l.)

Nous espérons que vous trouverez nos commentaires utiles. Nous serions heureux d'en discuter avec vous au moment qui vous conviendra.

Veuillez agréer, Monsieur, l'expression de nos sentiments distingués.

Penny Woolford
Présidente, Comité sur la fiscalité
Comptables professionnels agréés du Canada

Mitchell Sherman
Président, Section du droit fiscal
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The Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada is pleased to provide you with this written submission on certain aspects of the draft legislative proposals released on September 13, 2013 (the "**Proposals**").

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the *Income Tax Act* (Canada) (the "**Act**") as proposed to be amended under the Proposals.

1. Scope of Explanatory Notes

The legislative proposals include very detailed Explanatory Notes ("**Notes**") which include both descriptions of some of the new rules and illustrative examples. As a general matter, detailed Notes are helpful in assisting taxpayers, their advisors and courts in understanding the purpose and scope of the legislation. This can be especially helpful where there is an express intent to include some types of transactions but not others.

Having said that, detailed Notes are not an adequate substitute for appropriately targeted legislative language. We have noted an increasing tendency for newly enacted provisions to be worded in a way that is seemingly very broad, but then to be accompanied by apparently limiting language in the Notes. At a certain point, this approach runs the risk of undermining the goals of predictability and fairness. If two arguably similar situations are both seemingly caught by the legislation, and one (but not the other) of those situations is specifically adverted to in the Notes, how are tax advisors, the CRA or the courts to know what to do? Inevitably, it seems, the CRA is likely to read "relieving" language in Notes very narrowly, if not legalistically, and courts may well give little weight to comments in the Notes where the legislation is thought to be sufficiently clear and unambiguous.

The Proposals on derivative forward agreements ("**DFAs**") and synthetic disposition arrangements ("**SDAs**") include some relatively extreme instances of this trend. In our view, while some of the detailed discussion in the Notes is very helpful and should remain in the Notes, there are some underlying principles that should be "elevated" from the Notes to the legislation.

DFAs

In the case of DFAs, one of the illustrative examples deals with exchangeable shares. Exchangeable shares are a widely used type of security designed to accommodate cross-border merger and acquisition transactions where a taxpayer would otherwise exchange securities for shares of a non-Canadian corporation. Many years ago, the possibility of an explicit Canadian-for-foreign share-for-share rollover rule was studied but then not implemented and, as a result, it is well known, and accepted by the CRA, that taxpayers may utilize exchangeable share structures in order to provide a rollover in such situations.

The Notes describe a typical exchangeable share, where the exchange right is structured fundamentally as a retraction right embedded in the share terms.[1] The Notes then assert that the

[1] In fact, there are normally ancillary rights (generally thought to have nominal value) under a "support" agreement or other similar agreements in order to ensure, among other things, that in a situation where the

taxpayer retains a sufficient economic exposure to the exchangeable shares such that the DFA rules do not apply. However, the Notes add that if the shares did not have an embedded exchange right, but instead the exchange feature was purely contractual, the DFA rules would apply.

It appears that the Notes reflect an underlying principle to the effect that rights embedded in share terms do not, in and of themselves, constitute "an agreement … to purchase or sell a capital property". This is the only way of rationalizing the comments in the Notes. This principle seems to us to make perfect sense, and as it seems to be the principle underlying the tax policy, we believe the best way to ensure the intended result is to actually articulate this principle in the legislation itself.

Recommendation

We believe it would be appropriate for the legislation itself to state that, for the avoidance of doubt, a *bona fide* exchange right included in the terms of a share of the capital stock of a corporation is not a DFA. This provision should be added to the definition of DFA in subsection 248(1). In addition, the legislation should be clarified to ensure that the typical agreements arising in an exchangeable share structure will not, on their own, cause the DFA rules to apply.

SDAs

As noted below, the SDA Notes include a series of examples which appear intended to illustrate the difference between "real" and other risks. The premise of Example 4 is that sometimes there may be a "real" risk of regulatory approvals not being obtained; the implication seems to be that on other occasions there may not be a "real" risk of not obtaining such approval, though no guidance is provided as to how to distinguish these situations.

In real business situations, any time the consummation of a transaction depends on the approval of a third party – be it a government regulator, a landlord, a supplier, a union or any other third party – there is a "real" risk that the transaction may not proceed. Taxpayers may have subjective or even objectively justifiable views as to the likelihood of such true conditions precedent not being fulfilled, but any rule that attempts to measure the likelihood of such a condition being met is destined to create confusion and uncertainty. As noted below, we are recommending that the legislation expressly exclude a situation involving *bona fide* conditions precedent. An anti-avoidance rule could be included to address contrivances whose main purpose is to defeat the rules. The point here is that the basic scope of the rule is much more appropriately articulated in the legislation than in the Notes.

The Notes also assert that default risk arising from counterparty credit-worthiness is not to be taken into account in making the "highly factual" determination of whether an arrangement is an

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Canadian issuer of the exchangeable shares is legally precluded from redeeming due to solvency constraints, the holder then has a direct put right. As well, there is invariably an overriding call right obtained by the foreign parent or another entity in the group which allows that entity to "intercept" any redemption and instead acquire the exchangeable share in exchange for the underlying share. If the legislation is not amended as noted in our recommendation, it would be helpful if the description in the Notes could specifically advert to these typical features in order to clarify that a typical exchangeable share really is intended to not be caught.

SDA. No explanation of the underlying principle is provided and, with respect, we question the soundness of this proposition, and suggest that this comment either be re-considered or be explained.

2. Synthetic Disposition Arrangement

Proposed section 80.6 contains new rules that generally deem a taxpayer to have disposed of and reacquired property at its fair market value at the time the taxpayer enters into a "synthetic disposition arrangement" in respect of the property that has a "synthetic disposition period" of one year or more. A synthetic disposition arrangement generally is any agreement or series of agreements or arrangements that have the effect of eliminating all or substantially all of a taxpayer's risk of loss and opportunity for gain or profit in respect of property. As discussed with you following the release of Economic Action Plan 2013, we continue to believe that these rules are overly broad in many respects, and should be limited to the class of tax-motivated financial transactions at which they are ostensibly directed so that they do not affect ordinary commercial transactions. We also believe that there are a number of improvements that could be made to the rules.

Gain Reversal if Arrangements Never Close

As proposed, the synthetic disposition rules deem a taxpayer to have disposed of property at the time the synthetic disposition arrangement is entered into, regardless of whether the relevant arrangements are ever completed. For instance, one of the examples in the Notes contemplates an arrangement to sell 100 shares with a current fair market value of $100 in five years for $120 (which is reduced by the amount of dividends paid on the shares). The Notes indicate that this arrangement will be considered to be a synthetic disposition arrangement, and state that the creditworthiness of a counterparty is not generally a factor to consider in the determination of whether an arrangement is subject to the rules. Accordingly, the consequence of this arrangement is that the taxpayer is deemed to have disposed of the shares for proceeds equal to their fair market value at the outset, even if no cash or other property is received by the taxpayer in the form of a loan or otherwise, and even if the counterparty ultimately defaults or the sale is never consummated for some other reason. As currently drafted, there is no provision under which this deemed disposition may be nullified under any circumstances. We submit that this result is inappropriate. An analogous situation may be found in section 49 of the Act, which includes provisions to retroactively adjust the tax consequences to a taxpayer of having granted an option where that option is subsequently exercised (subsection 49(3)) or, in the case of an option to acquire shares or debt of the taxpayer, where that option expires (subsection 49(2)).

Recommendation

We recommend that a rule be added that reverses (as of the time of the initial gain) any deemed capital gain or deemed income inclusion that arises as a consequence of a taxpayer entering into a synthetic disposition arrangement, if the sale of the property pursuant to the arrangement does not occur because of the failure of the counterparty to complete the purchase. This supporting rule could be based on the same concepts as those underlying section 49.

Reserve

The rules deem a taxpayer to have disposed of property at its fair market value at the time the synthetic disposition arrangement is entered into, regardless of whether the taxpayer (or anyone else in the taxpayer's group) receives or otherwise realizes any cash or other property, whether in the form of a loan or otherwise. When a taxpayer actually disposes of capital property, section 40 generally allows a reserve to the extent that the taxpayer has not realized proceeds of disposition, subject to the requirement that the taxpayer recognize at least 20% of the gain in the year of disposition and each year thereafter. Reserves are also available for other situations in which income is recognized in advance of being earned or received. These existing provisions give effect to the "realization principle", a fundamental principle underlying various provisions of the Act and Canadian tax jurisprudence. Perhaps it was intended that deemed dispositions of capital property arising under section 80.6 be taxed in the same way as actual dispositions under instalment sales arrangements, such that they would qualify for a reserve, although this is not at all clear, and the Notes make the unqualified statement that the taxpayer will have an "immediate capital gain" equal to the gain in the property subject to the arrangement. For example, it is not clear whether the amount payable under the arrangement in the future (for which there may not yet be an unconditional payment obligation as a commercial matter) would entitle the taxpayer to a reserve in respect of the deemed proceeds.

We submit that, if a taxpayer is deemed to have disposed of property under the SDA rules, the taxpayer should be able to claim a reserve to the same extent as if a "real" disposition had taken place in circumstances where neither the taxpayer nor a person dealing at arm's length with the taxpayer has received property that could reasonably be regarded as proceeds in respect of the deemed disposition (whether such amounts are received in the form of a loan or otherwise).

We note that in some circumstances there may be good commercial reasons for structuring a transaction as a forward sale (with payment due only at closing) rather than a sale for a "vendor take-back" note or mortgage. For example, the latter transaction could not be consummated if third party consents were not yet forthcoming or if the parties wished to time the imposition of transfer taxes, such as land transfer tax so that these taxes coincide with the actual flow of funds. We believe that these two types of situations (forward sale with delayed payment, and sale for vendor take-back debt) ought to be taxed in the same way, and this would be achieved by providing that the deemed disposition would be treated like an actual disposition, and therefore eligible for instalment sale reserve treatment.

Recommendation

Section 80.6 should explicitly provide that to the extent neither the taxpayer nor a person not dealing at arm's length with the taxpayer has received any property (whether in the form of a loan or otherwise) that may reasonably be considered to be proceeds in respect of such disposition, the applicable reserve provisions in the Act would apply to allow the taxpayer to claim a reserve to the same extent as if the taxpayer had actually disposed of the property for proceeds of disposition equal to fair market value.

Conditions Precedent to Closing

The Explanatory Notes indicate that an arrangement will not be a synthetic disposition arrangement where there is a "real" risk that regulatory approval will not be obtained. In contrast, a change in the creditworthiness of the counterparty might not be a risk to consider in making a determination as to whether the arrangement is subject to the rules. As a business matter, both types of risk (and many other deal risks) are "real" and are in fact taken into account by parties in negotiations, and the relative weighing of the risk depends on each party's own subjective determination of the likelihood that it will materialize.

We have a number of concerns in this regard. First, with respect, it is not clear what is meant by a "real" risk, particularly in the context of a consent or approval that is mandated by law or contract. If "real" means the opposite of contrived or artificial, that should be fine. However, if "real" means that parties must risk-assess the likelihood that approval will ultimately be obtained, we would have a significant concern with such a rule. Where the approval is beyond the control of the parties, we think it is more reasonable for the rules to simply not apply even if the subjective views of the parties are that there is a high degree of confidence that the approval will ultimately be obtained. Second, and more generally, we submit that the wording of the legislation itself makes it difficult to discern a meaningful distinction between "real" regulatory risks and other types of risk. To ensure that the SDA rules do not affect ordinary commercial agreements where closing is deferred for reasons beyond the parties' control, such as the need to obtain regulatory or other third party consents, we believe that the legislation should have a specific exclusion for true *bona fide* conditions precedent. This exclusion could include an anti-avoidance rule to counter contrived or artificial conditions precedent, such that the exclusion would not apply if one of the main purposes for the need to receive consent was to avoid the application of the SDA rules.

Recommendation

The SDA rules should specifically exclude arrangements where there are *bona fide* third party conditions precedent to closing.

3. Derivative Forward Agreement

Potential for Very Broad Application

The proposed definition of DFA could be interpreted to apply to almost any forward sale agreement that extends beyond 180 days, as it could be argued that such agreements have an element of interest inherent in the forward sale price. The definition of DFA requires only that the difference between sale price and fair market value be "attributable, in whole or in part, to an underlying interest" and, thus, any element of interest could cause the test to be met. Moreover, the income inclusion in proposed paragraph 12(1)(z.7) is equal to the entire amount by which the sale price exceeds the fair market value. The Tax Measures released with Economic Action Plan 2013 state that the rules are intended "to ensure the appropriate tax treatment of the derivative-based return on a derivative forward agreement". Furthermore, they state, "Any return arising under a derivative forward agreement that is not determined by reference to the performance of the capital property being purchased or sold will be treated as being on income account." Accordingly, it appears clear that the underlying intent of the DFA rules is that where only a

portion of the return under a DFA is derivative-based the income inclusion should be for that portion only.

Recommendation

Revise proposed paragraph 12(1)(z.7) to include in income only the derivative-based portion of the return on a DFA. Consider further revisions to the definition of DFA to reduce the scope of the rules to the intended purpose, including those set out below.

Currency Hedging

A typical currency forward transaction involves the purchase of one currency and the sale of another currency and may be used to hedge a taxpayer's exposure to the value of any given currency in connection with a particular capital property or liability on capital account. Accordingly, both paragraphs (b) and (c) of the proposed definition of DFA are relevant in determining whether a currency forward transaction is a DFA. The calculation of the forward price under a currency forward agreement takes account of: (i) the spot exchange rate at the time the forward agreement is entered into, (ii) the interest rate in the base currency, (iii) the interest rate in the secondary currency and (iv) the term of the agreement. The interest rate differential (which may be positive or negative depending on the relative strengths of the two currencies in question) results in a forward price where each party is indifferent based on the spot exchange rate at the time the forward agreement is entered into.

Based on subparagraph (c)(i) of the proposed definition of DFA, a typical currency forward sale agreement could be caught in many circumstances. A typical example may involve a forward sale of US currency for Canadian currency. A taxpayer may choose to sell forward USD$100 in a year to hedge its exposure to the US dollar. Assume that the one year forward rate results in the taxpayer receiving CAD$110 in one year in exchange for USD$100 to be paid on the one year maturity date and that, based on the current spot rate, USD$100 has a fair market value of CAD$105 at the time that the forward agreement is entered into. In this case, the sale price of the property is fixed at CAD$110 and the fair market value of the property at the time of that agreement is CAD$105 resulting in a difference of CAD$5 for purposes of subparagraph (c)(i) of the proposed definition of DFA.

In any currency forward sale agreement, as in the example above, the forward price is fixed and there is no optionality. In addition, the fair market value of the property at the time the agreement is entered is fixed. Since the sale price of CAD$110 is based on the forward rate (which is based in part on the interest rate differential described above), the difference between the sale price of the property and the fair market value of the property at the time the agreement is entered into (i.e., CAD$5) will be attributable in part to a rate (i.e., an interest rate). This difference has been fixed at the time of entering into the agreement with the result that the exception in clause (A) will not be available in this example. The exception in clause (B) will also not be available in this example as the sale price of US dollars is denominated in Canadian dollars. If the agreement is part of an arrangement that extends for a period of more than 180 days, subparagraph (c)(ii) of the proposed definition of DFA would be satisfied as the agreement would have the effect of eliminating all of the taxpayer's risk of loss and opportunity for gain or profit in respect of the value of the taxpayer's USD$100. Similar issues could arise under paragraph (b) of the proposed definition of DFA in connection with a foreign currency forward purchase agreement.

While interest rates are a factor in determining the forward price under a currency forward agreement, there is no resulting conversion of gains on income account to capital gains, as interest rates are only relevant to take into account the different prevailing interest rates as between each currency involved in the forward agreement. This differential may be positive or negative depending upon the particular currencies involved.

Under the current law, the gain or loss on that transaction would be on capital or income account, based on common law principles (commonly referred to as linkage). The first paragraph in the Notes on the definition of DFA states that "Derivative forward agreements are typically used in an attempt to convert this fully taxable derivative income to a capital gain..." A currency forward transaction does not fit within that description and, presumably, the underlying intent of the rules is not for every currency forward to necessarily be a DFA; had that been the intended effect, one would have expected this to have been plainly stated in the Budget. The proposed definition of DFA should be revised to leave the existing law to determine if the gain or loss is on capital or income account.

Recommendation

Revise the proposed definition of DFA so that agreements where there is an exchange of money in one currency for a fixed amount of money in another currency would be excluded from the definition of DFA.

Interaction Between DFA Proposals and Section 49

The Notes make it clear that the DFA proposals are intended to apply to certain circumstances where a property is purchased or sold pursuant to an option. The use of the term "sale price" in proposed paragraphs 12(1)(z.7) and 20(1)(xx) leads to possible confusion where property is sold pursuant to an option. In this context, is this term meant to mean the exercise price pursuant to the option or is it meant to mean the proceeds of disposition (i.e., including the cost of the option)? A plain reading would suggest that "sale price" is more likely to be considered to be the exercise price under the option. This could result in an anomalous result as is illustrated by the following example considering the sale of property pursuant to a deep in-the-money "call option" being sold by a taxpayer. Assume that a share has a fair market value of $100 at the time when a deep in-the-money call option is written by the shareholder. The shareholder would receive a $99 option premium and the strike price under the option would be $1.00. The adjusted cost base of the share to the shareholder is assumed to be $50.

Assuming that section 49 would apply to the receipt of the option premium, the shareholder would have a deemed capital gain at that time equal to $99 pursuant to subsection 49(1). When the option was exercised, the deemed realization of the capital gain described above should be reversed and the taxpayer should be considered to have disposed of the share for $100 (i.e., the $1.00 exercise price together with the $99 option premium).

If the sale price is considered to be the exercise price under the option and one of the main reasons for entering into this transaction is not considered to be the availability of a deduction under proposed paragraph 20(1)(xx), it would appear that the shareholder should be entitled to a deduction of $99, being the difference between the fair market value of the share at the time that the option was entered into and the sale price (i.e., exercise price?) under the option. Such

deduction should grind the adjusted cost base of the share from $50 down to negative $49 which would deem a capital gain to have taken place equal to such negative amount. Furthermore, the shareholder would still be considered to have disposed of the shares for $100 resulting in another capital gain equal to that amount. The end result would appear to be that the shareholder would have the $99 deduction from income pursuant to proposed paragraph 20(1)(xx) and a net capital gain equal to $51. While it might be argued that section 49 may not be applicable to the option (as it arguably does not have any optionality and) such that the shareholder may be considered to have received proceeds of disposition at the time it received the option premium (pursuant to clause (a) in the definition of "disposition" in subsection 248(1) of the Act), the deep in-the-money call option example has been chosen to illustrate the possible consequences. Clearly, it would be worthwhile to clarify that in circumstances where section 49 applies, the reference to sale price means the proceeds of disposition.

Recommendation

Amend proposal subparagraph 12(1)(z.7)(ii) and proposed clause 20(1)(xx)(i)(B) to clarify that, where an option is exercised, the sale price is equal to the exercise price plus the premium received for writing the option.

Terminated DFAs and Fund Mergers

The transitional rules dealing with DFAs include a provision which is intended to ensure that the combining of two forward agreements (such as would occur on a merger of mutual funds) would not in and of itself result in the loss of grandfathering (see factor D under clause 2(3)(a)(ii)(E) and factor E in subparagraph 2(3)(b)(ii)). Where there is a merger of two funds, a "surviving" DFA may be novated. Thus, it is not clear that the grandfathering would continue even if the requirements set out in the grandfathering rules were maintained. It would be useful to confirm that where the continuing agreement was considered to be novated simply because the surviving entity was a different legal entity than the one that had entered into the contract, such contract would be deemed to be the same contract for purposes of these transitional rules.

Recommendation

Add the words "or to a novated derivative forward agreement" after the words "derivative forward agreement" in factors D and E, referred to above.

Buying Purchase Options

Our understanding is that subparagraph (c)(ii) of the proposed definition of DFA was introduced in order to allow taxpayers to write covered call options without running afoul of the rules. A corresponding provision was not inserted in paragraph (b). There may be circumstances where taxpayers purchase call options (options to purchase) that are not part of a put/call strategy that should not be caught by these rules. It would be useful to add in paragraph (b) a provision similar to proposed subparagraph (c)(ii).

Recommendation

Amend proposed paragraph (b) of the DFA definition to include a provision similar to that found in subparagraph (c)(ii).

Further Clarification on Call Options

The example in the Notes dealing with a covered call option is helpful, but it would be useful to cover circumstances where the option written is in-the-money (which is not uncommon). It would be helpful to have a second example using a strike price of $95, and clarification that in such a scenario the option would not be caught because the writer/taxpayer still retains a majority of the risk of loss notwithstanding that the entire opportunity for profit or gain in respect of the property has been given up. Presumably, this is consistent with the intent as the language in subparagraph (c)(ii) of the proposed definition of DFA refers to eliminating a majority of both the risk of loss and the opportunity for gain or profit. This example could be put between the two existing paragraphs, leaving the put/call scenario to apply to both out-of-the-money and in-the-money covered call options.

Recommendation:

Expand the Notes to include the example described above and to confirm that in interpreting subparagraph (c)(ii), the "risk of loss" and the "opportunity for gain or profit" are two separate concepts and a majority of both must be eliminated for the agreement to be a DFA.

4. Changes to the Thin Capitalization Rules

The thin capitalization rules in subsection 18(4) are being extended to trusts. Equity of a trust resident in Canada will be determined with reference to the tax-paid earnings of the trust for the year and the average of equity contributions to the trust to the extent made by a specified non-resident beneficiary of the trust.

In our view, in some circumstances the equity of a trust should be determined on a basis comparable to the equity of a corporation. The equity of a corporation is based on three components: paid-up capital, contributed surplus and retained earnings. Beneficial interests in a trust can be subscribed for by beneficiaries in a manner comparable to subscriptions for shares and, like shares, may be transferred by one beneficiary to another person without any property being transferred to the trust. This is particularly true in the case of "commercial" trusts (such as certain mutual fund trusts or unit trusts). While a trust may not differentiate between contributed surplus and equity, in our view, it is appropriate that the equity of a trust resident in Canada include an amount analogous to paid-up capital whether that capital arose as a result of a contribution by a specified non-resident beneficiary or otherwise, provided that the capital is attributable to a specified non-resident beneficiary at the beginning of the month. We recognize this approach may be difficult in the context of discretionary trusts where, until a discretion is exercised, it may be difficult to determine the beneficiary to which any particular capital is attributable and in that context see the merit in the proposed approach. However, in the context of trusts where the interests of the beneficiaries in the capital of the trust are determined by reference to the number of units held, a more appropriate definition of equity would be based on the proportionate capital of specified non-resident beneficiaries.

Recommendation:

Amend paragraph (b) of the definition of equity so that:

1. a new clause (C) is added applicable to a trust that is an *inter vivos* trust under the terms of which the interest of each beneficiary is described by reference to units of, or other fixed interests in, the trust and the amount of capital that each beneficiary is entitled to receive as a beneficiary under the trust is based on the fair market value of units of, or fixed interests in, the trust held by the beneficiary as compared to the fair market value of all of the issued and outstanding units or fixed interests and provides that, in such case, the equity is the average of all amounts each of which is the trust's capital at the beginning of a calendar month that ends in the year, excluding the capital that is attributable to units of the trust owned by a person other than a specified non-resident beneficiary of the trust; and

2. clause (A) be amended so that it applies only to trusts that are not described in clause (C).

Further Comments Regarding Trust Equity

Subparagraph (b)(ii) in the definition of "equity amount" reduces a Canadian resident trust's equity for thin cap purposes by the amount of any distributions paid or payable by the trust to a beneficiary before the relevant time, unless those distributions were treated as income in the hands of the beneficiary under either subsection 104(13) (clause (A)) or paragraph 212(1)(c) (clause (B)), or were paid or payable to a person who was not a specified non-resident beneficiary (clause (C)).

The wording in clause (B) as drafted in the Proposals applies only to amounts "from which tax was deducted under Part XIII" and accordingly does not capture amounts paid or payable to a non-resident beneficiary who was entitled to a full exemption under a tax treaty. For example, under paragraph XXII(2) of the Canada-U.S. Treaty, foreign source income distributed by a Canadian resident trust is fully exempt from Canadian tax. It is submitted that the availability of a treaty exemption should not prevent a distribution from being classified as a distribution of income for thin cap purposes.

Recommendation:

Revise clause (b)(ii)(B) in the definition of "equity amount" to read as follows:

"(B) an amount from which the trust was required, or would have been required but for the provisions of an applicable tax treaty, to deduct tax under Part XIII because of paragraph 212(1)(c), or"

5. New Section 251.2

Typical Family Trusts or Similar Trusts Should be Exempted

We understand that new section 251.2 is part of a package of legislative amendments that are intended to extend loss-streaming and related rules, which currently apply to corporations, to trusts. Specifically, where a person becomes a "majority-interest beneficiary" of a trust, or a group of persons becomes a "majority-interest group of beneficiaries" of a trust, the trust undergoes a "loss restriction event".

As a preliminary matter, we observe that trusts are used for a wide variety of philanthropic, family and other legitimate non-tax purposes that often differ from the uses of corporations. Often such trusts are discretionary (i.e., the trustee(s) are empowered to make certain decisions with respect to distributions to beneficiaries and, in some cases, to add new beneficiaries). Nonetheless, to a significant degree the approach taken in these rules has been to simply make the rules applicable to corporations, which typically undertake commercial enterprises, and apply them universally to trusts which, particularly in the family context, will rarely if ever carry on commercial activities.

We understand that the proposed measures are intended to curtail loss trading through the use of trusts and that it is not intended that many of the typical transactions or events involving changes in the beneficiaries of a personal trust will result in the application of the rules. However, we submit that the rules, as currently proposed, could well apply in apparently unintended circumstances to many of the typical transactions or events involving personal trusts. For example, the addition of a charity, distant relative or family friend as a beneficiary, or an undertaking to make distributions to that person, could cause the person to become a majority-interest beneficiary and trigger a loss restriction event for the trust. Even where the rules do not apply, the mere possibility of their application to typical family trusts will require those trusts to consider the rules in a variety of circumstances where there is clearly no loss trading taking place. We submit that, by potentially subjecting typical family trusts to the new rules, such trusts will be burdened with compliance costs that serve little or no useful purpose.

The discussion below will, we believe, highlight a number of the difficulties with applying these rules as broadly as proposed. A number of these difficulties, but not all, would be addressed by excluding personal trusts from their application. In our view, even if personal trusts are excluded, the rules as written need modification.

Recommendation:

If trust loss trading is taking place, our expectation is that interests in the trust necessarily will be acquired for consideration. We believe that a broad exception should be put in place to ensure that the rules do not apply unless a beneficial interest in the trust is acquired for consideration (whether paid to a beneficiary of the trust or to the trust itself). In our view, this could be achieved by exempting from the rules all "personal trusts" as defined in subsection 248(1).

Majority-Interest Beneficiary

Unlike the well-established "bright line" acquisition of *de jure* control rules applicable to corporations, the Act essentially treats any person with an absolute or contingent right, immediately or in the future, to any income or capital of the trust as being a beneficiary of the trust, pursuant to subsection 248(25) and the definition of "beneficiary" in subsection 251.1(3) and proposed subsection 251.2(1). Indeed, the mere ability under the terms of a trust to add a person as a beneficiary in the future arguably is sufficient to cause every such person to be viewed as a beneficiary now. Under this interpretation, for some trusts, every person in the world is a "beneficiary" of the trust for purposes of the Act.

The existence of a majority-interest beneficiary or group of beneficiaries requires determining what the value of the person or group's interest in the trust is relative to all other interests in the

trust. In the case of non-discretionary trusts, such values may well be readily determinable. However, it is difficult to determine what, if any, value would be attached to a beneficial interest in a discretionary trust. Paragraph 251.1(4)(d) addresses this issue for purposes of determining whether a person is affiliated with a trust but not for the purposes of the definitions in section 251.1, or for purposes of section 251.2. Notwithstanding the *Olsen*[2] decision, it would seem doubtful that subsection 251.1(4) would apply for purposes of the definitions as applied in section 251.2.

If subsection 251.1(4) does not apply, presumably determining the value of beneficial interests in a trust requires a relatively clear determination of what rights a beneficiary might have under any applicable law (which no doubt would vary from province to province or even country to country depending upon the law governing the trust, the situs of trust property, and the location of the trustee(s) and beneficiary(ies)). Presumably in some situations the rights of a beneficiary under a trust could also be affected by what prior distributions of income or capital have been made to the beneficiary, or other persons. In short, we submit that the valuation of a beneficial interest in a trust may not be straightforward. This issue is avoided in the affiliated person rules by simply deeming any discretion to be exercised in favour of the beneficiary at issue, for purposes of valuing that person's interest. As noted above, we believe that in the context of a personal trust the rules in section 251.2 should simply not apply.

We note that if subsection 251.1(4) does apply for purposes of section 251.2, the addition of any beneficiary under a discretionary trust arguably will result in that person becoming a majority interest beneficiary. We submit that in many cases it would be inappropriate for the addition of a beneficiary to result in a loss restriction event. If our recommendation that personal trusts be exempted is accepted, some of those concerns would be alleviated. Nonetheless, as discussed below, the exemption of personal trusts by itself will not resolve all the issues.

Recommendation:

We recommend that a rule like that in subsection 251.1(4) be included in section 251.2, perhaps as an additional paragraph to subsection (5).

Specific Exceptions Need to Contemplate New Persons and New Relationships

The exceptions found in subsection 251.2(3) are too narrow and need to contemplate new persons coming into being, new relationships and a broader category of relationships, particularly in the context of family trusts or estates. For example, a person may become a beneficiary of a trust immediately upon birth or otherwise coming into being, but will not have been affiliated with anyone before birth or otherwise coming into being. A person may also become a beneficiary of a trust immediately upon the commencement of a marriage or common-law partner relationship, but similarly will not be affiliated with the trust before that relationship commenced. The specific exceptions need to contemplate these possibilities (see, by analogy, subsection 69(14)). Nieces, nephews, cousins, and other relatives who acquire a beneficial interest in a trust may not qualify for the current specific exceptions. The specific exceptions do

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2 *The Queen* v. *Olsen* 2002 DTC 6770 (FCA).

not include beneficiaries that are charities or who may have had another relationship with the individuals who established the trust (e.g., friend, employee, godchild, etc.).

Given the broad spectrum of events that could trigger a loss restriction event of a personal trust, the rules complicate the determination of when an event has taken place. While it is relatively easy to determine when shares of corporations change hands, it is much more challenging to determine when, for example, a common-law relationship begins or ceases. With many discretionary trusts, the birth of a new beneficiary could create a taxation year of a trust. Indeed, a trustee may not be aware of a marriage, death, birth or the commencement of a common-law relationship for some time following the relevant event. Trusts, unlike corporations, must file a tax return within 90 days of its taxation year. This increased compliance burden and the potential negative consequences do not seem warranted in these circumstances. Consider the following example:

A spousal trust is created upon the death of an individual. The couple did not have any children and decided that their nieces and nephews should inherit the capital of the trust upon death of the spousal beneficiary. There is no exception available within the rules to exempt this trust from a loss restriction event upon the death of the spousal beneficiary.

Recommendation:

Broaden the exemptions to include related persons and introduce a rule analogous to, but broader than, subsection 69(14) so that the creation of new persons or new relationships by itself does not result in a loss restriction event. Special rules should be introduced so that the inclusion of charities as beneficiaries of a trust does not by itself result in a loss restriction event.

Drafting of Subparagraph 251.2(3)(a)(iv)

There appears to be a small drafting error in subparagraph 251.2(3)(a)(iv) in that there is a reference to the estate acquiring "the property" from the individual. We believe the reference to the property must mean "the equity" as there is no other property that appears relevant.

Recommendation:

Amend subparagraph 251.2(3)(a)(iv) to substitute "equity" for "property" so that it reads as follows:

"a particular person from an estate that arose on and as a consequence of the death of an individual, if the estate acquired the **equity** from the individual as a consequence of the death and the individual was affiliated with the particular person immediately before the death;".

Nature of Trust Activities

If estates are subject to the new rules, we expect there will be a variety of circumstances where the rules would be triggered in inappropriate circumstances (e.g., to preclude loss carry backs under subsection 164(6)). Indeed, in most cases the assets of an estate or *inter vivos* family trust may consist entirely or almost entirely of capital assets and its sources of income may be limited to property source income or capital gains. In our view, it would be inappropriate to preclude capital losses or property source losses realized in one year by a trust from being carried forward

or back by the trust solely on the basis of changes in beneficiaries (for example, by virtue of a marriage, birth or death) when no loss trading purpose or result is present. While trusts are used for a wide variety of purposes, they do differ in many respects from corporations and in particular assets cannot be transferred to a trust on a tax-deferred basis, the losses of a trust cannot be passed out to the beneficiaries and trusts cannot be readily combined on a tax-deferred basis. Thus, in our view, the restrictions on a trust's use of its own tax attributes should be more relaxed than those applicable to corporations.

Recommendation:

Extend relief from the restrictions on loss carry forwards and carry backs (including for net capital losses) for trusts where there has been no loss trading so that notwithstanding a loss restriction event, losses incurred prior to or following the loss restriction event may be carried forward and back to reduce the trust's income (including taxable capital gains) from the same or similar activity. (By analogy consider the definition of relevant loss balance in section 80 and the exception from the loss restriction rule in subsection 111(5) to accommodate the paragraph 110(1)(k) deduction.)

Resource Pools of Trusts Should not be Subjected to New Rules

Unlike corporations, trusts may be subject to alternative minimum tax (AMT). Resource pool deductions generally are limited to the income derived from resource properties for purposes of computing AMT income.

Consequently, trust loss trading that attempted to use resource pools to shelter income that was not from the same or a similar business generally would result in AMT. Given that result, it seems unlikely that, in practice, resource pools of trusts would be used to shelter income that was not from the same or similar business.

The successor rules were introduced in the 1950s as a beneficial rule (i.e., to allow a corporate purchaser of resource properties to acquire and deduct the original owner's resource pools, subject to various limitations). (The beneficial aspect of the rules still only applies to corporations. See section 66.7.) In 1981, the successor rules were modified to apply to acquisitions of control of corporations to limit resource pool deductions, as described above.

If trusts are only subject to the acquisition of control aspects to the successor rules, and are not able to use the beneficial aspects, they would be treated more harshly than corporations that are similarly situated.

Given that the AMT regime effectively already enforces a same or similar business requirement, applying the trust loss trading rules to resource pools would introduce significant complexity to prevent a loss trading problem which, in practice, would seldom (if ever) arise except between same or similar businesses.

Recommendation:

We recommend that resource pools not be subjected to the trust loss trading rules.

Alternatively, if resource pools are subjected to the trust loss trading rules, the rule should apply based on a "same or similar" business test or trusts should be entitled to take advantage of the beneficial aspect of the successor rules in addition to being subjected to the adverse acquisition of control aspect of the successor rules.

Majority-Interest Group of Beneficiaries or Partners:

Pursuant to subsection 251.2(2), a trust will be subject to a loss restriction event if a person becomes a *majority-interest beneficiary*, or a group of persons becomes a *majority-interest group of beneficiaries* of the trust. For this purpose, subsection 251.1(3) provides certain exceptions. The term *majority-interest group of partners* is relevant for that purpose. Each of those terms is defined for this purpose in subsection 251.1(3).

We are particularly troubled by the definitions of majority-interest group of beneficiaries and majority-interest group of partners because they arguably do not require any connection among the members of the group beyond the requirement that they be beneficiaries of the trust or members of the partnership, respectively. While in the context of the phrase "group of persons that controls a corporation" the courts have concluded that there must be connection between the members of the group beyond simply being shareholders of the corporation, that conclusion was reached in the context of determining whether a group had control. Control, by definition, requires some collective action. Indeed, in *Silicon Graphics*,[3] Sexton, J.A. for the Federal Court of Appeal emphasized the significance of control to that conclusion:

> In *Buckerfield's, supra* at page 5303, Jackett P. said:
>
> The word "group" in its ordinary meaning, as I understand it can refer to any number of persons from two to infinity.
>
> In the context of control, the phrase "one or more persons" surely must mean the same thing and I am therefore of the view that the concept of "a group of persons" and the case law attendant thereon is applicable when interpreting the definition of CCPC in subsection 125(7). **The significant word is "control" and in my view "control" necessitates that there be a sufficient common connection between the several persons referred to in that definition in order for there to be control by those several persons**. …(Emphasis added.)

In most places in the Act where the phrase "group of persons" is used, it is in the context of identifying a group of persons that controls and, as Sexton, J.A. points out, in that context a link is needed to establish a controlling group. In other contexts in which the phrase is used in the Act, some connection among the members is expressly identified. For example, in subsection 46(3), a person can be a member of the group of persons only if the person does not deal at arm's length with other members of the group; in subparagraph 248(37)(f)(ii), each member of the group must be related to the shareholder in question.

In contrast, the definitions of majority-interest group of beneficiaries and majority-interest group of partners have nothing to do with control; no connection arguably is required among the

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[3] *Silicon Graphics Limited* v. *The Queen* 2002 DTC 7112 (FCA) at paragraph 54.

members of the group beyond collective entitlement to a majority of the beneficial interests in the trust or partnership by a group, i.e., by "any number of persons from two to infinity".

The broader meaning of group is of far less concern in the context of section 251.1 where the definitions in issue are used to affiliate two or more trusts or partnerships because, in that context, identification of a common group of beneficiaries or partners between the two is required. Again, there is a link – each member of the group must be a beneficiary of both trusts or a partner of both partnerships – the required connection is being a beneficiary or partner in both majority-interest groups.

Section 251.1(2) simply requires a group of beneficiaries to be identified that are entitled to a majority of the trust interests. For a trust (or partnership) which does not have a majority-interest beneficiary (or majority-interest partner), there is simply no guidance as to which persons should be identified as constituting the majority-interest group. It is both unsatisfactory and unworkable that the rule permits random selection of beneficiaries and partners. It cannot have been intended that there would be a loss restriction event for a trust, including a unit trust or mutual fund trust, simply because there are changes in the identity of the beneficiaries of a trust as a whole.

Consider the following example. A unit trust ("UT") has ten unitholders each of whom owns 10% of the 1,000 trust units. The unitholders are not affiliated with one another and have no connection other than their interests in UT. UT determines to raise additional capital by issuing 1,000 new units. All of the new units are acquired by a single investor. As a result of the issuance of new units, there is a loss restriction event (the new investor owns 50% of the units and so, by definition, becomes a member of the majority-interest group of beneficiaries). None of the exceptions in subsection 251.2(3) applies. New investor and one of the other unitholders will become a majority-interest group of beneficiaries: i.e., a group of persons each of whom is a beneficiary under UT such that (a) if one person held all of their units, that person would be a majority-interest beneficiary of UT and (b) if any member of the group were not a member, the test in (a) would not be met.

The same result would occur if each of the unitholders disposed of 40% of their units to one or more purchasers (so that the "old" unitholders continued to hold, as a group, 60% of the units). While it might then be said that no purchaser need be a member of the majority-interest group, in order to satisfy the test in (a) (because the "old" unitholders collectively own 60% of the units) and so there is no "new" majority-interest group of beneficiaries, it is not clear that interpretation would change the result. There nonetheless would be a new majority-interest group of beneficiaries because all but one of the "old" UT unitholders would need to become members of the majority-interest group to satisfy the test in (a) while, prior to the transfer of units to the purchasers, a majority-interest group of beneficiaries would not have required all of "old" unitholders to have been included – any six would have been sufficient. However, it is not clear how the majority-interest group would have been selected from all available beneficiaries. This lack of certainty is troubling.

In contrast, were UT a corporation, these same transactions would not result in an acquisition of control of UT.

Similarly, consider the exceptions in paragraph 251.2(3)(d) which are intended to address circumstances in which the equity of a particular trust is transferred to a partnership or another trust but there is no "real change" in ownership of the equity – rather it is "held" in a different way – being, through a corporation, partnership or trust. However, where the particular trust does not have a majority-interest beneficiary, it is not clear whether the test can ever apply. First, it only applies where there is a majority-interest group of partners. Based on the discussion above, every trust that does not have a majority-interest beneficiary will have one or more majority-interest group of beneficiaries, although it will not be clear which beneficiaries should be selected. However, even so, the conditions in clauses (ii)(B) and (C) can never be met. Returning to the example, if all of the UT unitholders transfer their UT units to a partnership or trust, the only partners or beneficiaries of which are those unitholders in the same percentages as they owned equity of UT before the transfer, there should be no loss restriction event. This is the very transaction which is intended to be excluded. Yet, because all of the UT unitholders are not required to form a majority-interest group, the acquiring partnership or trust will have members and beneficiaries respectively who were not part of the majority-interest group of beneficiaries of UT immediately before the transfer. The rule is simply unworkable.

While we recognize that there are differences between corporations and trusts, a trust should be subject to a loss restriction event in respect of changes in its beneficiaries in circumstances similar to those in which a corporation would be subject to a loss restriction event by virtue of changes in share ownership that result in an acquisition of control. In our view, a trust should be subject to a loss restriction event if, and only if, a new beneficiary (either alone or together with one or more affiliates) acquires beneficial interests in the income or capital of the trust the fair market value of which represents more than 50% of the fair market value of all interests in the income or capital.

The definition of majority-interest beneficiary is sufficient for that purpose. In determining whether a person is a "majority-interest beneficiary" of a trust, the interests of that person and of all affiliated persons are aggregated. In our view, limiting the loss restriction event to a person becoming a majority-interest beneficiary should be sufficient, particularly in light of the extended definition of affiliated persons in subsection 251.2(5). Under this approach, the new investor would become a majority-interest beneficiary only if it was affiliated with another beneficiary who was not a majority-interest beneficiary. (The addition of a beneficiary who is affiliated with the majority-interest beneficiary should not result in a loss restriction event although this does not appear to be addressed in the exemptions in subsection 251.2(3). This should be addressed.) This approach would be analogous to that applicable in the context of a corporation.

Recommendation:

Limit loss restriction event in the context of a trust to circumstances in which there is a new majority-interest beneficiary other than a majority-interest beneficiary which was, immediately before that time, affiliated with the majority-interest beneficiary.

Inadequate grandfathering:

If a person or group of persons acquires a majority-interest in a trust under the terms of a trust or binding agreement that existed prior to the Budget Date, the acquisition of the interest pursuant

to such terms or agreement should not result in the trust becoming subject to a loss restriction event. Paragraph 251.2(3)(e) is not broad enough because it applies only where there is an agreement in writing between the parties. A trust agreement may establish that persons or a group of persons will, on the happening of an event, become beneficiaries of the trust without the beneficiaries being party to the trust agreement.

Recommendation:

Extend grandfathering to the acquisition of equity of a trust pursuant to the terms of the trust that existed prior to the Budget Date.

Paragraph 256(7)(h)

Paragraph 256(7)(h) provides that if a trust is subject to a loss restriction event and, immediately before that time, the trust controls a particular corporation or is a member of a group of persons that controls a particular corporation, control of the corporation and each corporation controlled by it is deemed to have been acquired by a person or group of persons.

We accept that if a trust is subject to a loss restriction event, it would be consistent with the acquisition of control rules that there be a simultaneous acquisition of control of any corporation controlled by the trust. However, paragraph 256(7)(h) goes further and, if enacted as proposed, will significantly expand the circumstances in which control of a corporation is considered to be acquired. In our view, there should not be an acquisition of control of a corporation simply because one of the members of the group of persons that controls it is a trust.

Consider the example of a private corporation (Privco) with three shareholders (A, B and C), each of whom owns one-third of the shares of Privco. The three shareholders deal with each other at arm's length and have no connection beyond being joint shareholders of Privco. Having regard to all the facts and circumstances, it is determined that either A and B together act to control Privco or that all three shareholders act together to control Privco so that it is clear that Privco is controlled by a group of persons consisting of either A and B or A, B and C.

Pursuant to paragraph 256(7)(h), if A is a trust that is subject to a loss restriction event, there will be an acquisition of control of Privco. If instead A is a corporation, an acquisition of control of A would not result in an acquisition of control of Privco and Privco would not be subject to a loss restriction event.

In our view, the nature of the taxpayers that comprise the group of persons that controls a corporation should be irrelevant to the analysis. Whether the group consists solely of trusts, solely of corporations or of a mix of trusts and corporations, the fact that one member of the group is subject to a loss restriction event should not automatically result in an acquisition of control of any corporation controlled by that group. If the group that controls the corporation does not change – in the example, whether A is a trust or a corporation, the group continues to consist of A and B or A, B and C – there should be no acquisition of control of the corporation.

Recommendation:

Amend paragraph 256(7)(h) so that it by deleting the phrases ", or a group of persons a member of which is the trust," and "or group of persons" so that it reads as follows:

> if at any time on or after Announcement Date a trust is subject to a loss restriction event and immediately before that time the trust controls a corporation, control of the corporation and of each corporation controlled by it immediately before that time is deemed to have been acquired at that time by a person; and

Paragraph 256(7)(i)

Although paragraph 256(7)(i) is intended to protect against an acquisition of control where there is a change in the trustee, because of the two conditions in subparagraphs 256(7)(i)(i) and (ii), we suggest it will rarely apply except in the context of commercial non-discretionary trusts. Moreover, as a relieving provision it is quite unsatisfactory.

A trustee is in a fiduciary relationship with the trust property and beneficiaries and must act strictly in accordance with the terms of the trust document for the benefit of the beneficiaries. Consequently, in our view, a change in the trustee should not be relevant to the issue of control of a corporation the shares of which are owned by the trust. In this respect, a change in trustees might be analogized to a change in directors and a change in beneficiaries analogized to a change in shareholders, with only the latter potentially giving rise to an acquisition of control of the corporation. To focus on changes in the beneficiaries would be consistent with the principles underlying the loss restriction events for trusts.

By virtue of subparagraph 256(7)(i)(ii), the safe harbour will never apply to a discretionary trust. Many family trusts (both *inter vivos* and testamentary) provide the trustees with some discretion in the distribution of income or capital. Even commercial trusts the terms of which require annual distribution of income may provide the trustees with the discretion to encroach on capital for the purposes of making a distribution. Consider a situation where the trustee of a discretionary trust has not provided adequate supervision of the investment advisors to a subsidiary corporation of the trust such that significant losses have accumulated. The decision to replace the trustee would appear to result in the accrued capital losses in the corporation being subject to loss restrictions even though there has been no change in trust beneficiaries or beneficial ownership of the corporation.

The condition in subparagraph 256(7)(i)(i) also appears to us to be unnecessary. Firstly, changes in beneficial interests in the trust will either result in a loss restriction event for the trust or will not, depending on the application of section 251.2. Unlike section 251.2, this condition does not have any exceptions. Thus, for example, if the change in trustee occurs because a trustee who happens to be a beneficiary of the trust dies, the condition could not be satisfied. Even in the context of a "commercial" trust, a change in beneficiaries might result in changes to the trustees (as a change in share ownership might result in a change of directors). However, unless there is a significant change in beneficiaries as described in section 251.2, the change in trustees should be irrelevant.

We acknowledge that if our recommendation that section 251.2 not apply to personal trusts is accepted, it may be necessary to preclude personal trusts from relying on this provision.

Recommendation:

We recommend that paragraph 256(7)(i) be amended to delete the conditions in subparagraphs (i) and (ii). The rules in section 251.2 should "cover the field" with respect to loss restriction events of trusts. If our recommendation that personal trusts be exempted from section 251.2 is accepted, we suggest that paragraph 256(7)(i) be amended so that it does not apply to personal trusts.

6. Section 256.1

Subsection 256.1(2)

The stated purpose of section 256.1 is to ensure appropriate tax consequences apply to transactions undertaken with the intention of circumventing provisions in the Act that constrain the trading of corporate tax attributes. Subsection 256.1(3) will deem control of a corporation to have been acquired at a particular time if the conditions of subsection 256.1(2) are satisfied. In general terms, those conditions will be satisfied if, at the particular time, a person or group of persons (the "controller") holds shares of the corporation (the "controlled corporation") with a fair market value that exceeds 75% of the fair market value of all of the shares of the corporation (the "75% value test") but does not control the corporation and, immediately before that time, the controller did not hold shares of the corporation with such value, provided that it is reasonable to conclude that one of the main reasons that the controller does not control the controlled corporation is to avoid the application of the specified provisions.

We have several concerns with this provision.

If it applies at a particular time and the controller subsequently acquires control of the corporation, there would appear to be a second acquisition of control of the controlled corporation. In our view, if a person or group of persons is deemed to acquire control of a corporation by virtue of this provision, a subsequent acquisition of control by that same person or group of persons should be deemed not to be an acquisition of control unless there has been an intervening actual or deemed acquisition of control by another person or group of persons. Similarly, if the provision has applied and the controller ceases to meet the 75% test as a result of a transaction or event which is temporary but, because it is not described in paragraph 256.1(4)(a) it cannot be ignored, on the termination of that transaction or event there would be a another deemed acquisition of control. Again, in our view, this should not occur.

Secondly, where subsection 256.1(3) applies, for as long as the controller meets the 75% test, the corporation and each corporation controlled by it is deemed not to be related to or affiliated with any person to which it was related or affiliated immediately before the deemed acquisition of control. This is inappropriate because that result would not arise if control of the controlled corporation were actually acquired. Moreover, this provision appears to apply for all purposes of the Act, a particularly harsh result. We observe that subparagraph 256.1(3)(a)(ii) deems the controller not to have control of the controlled corporation and any corporation controlled by it after the provision has applied solely because paragraph 256.1(3)(a) deemed the controller to

acquire control. In that context, the Explanatory Notes indicate that de jure control is not affected and would continue to rest with the person or group of persons that has such control so that, for example, the affected corporations would continue to be associated. However, that principle seems to be significantly eroded by virtue of paragraph 256.1(3)(b). The controlled corporation and its wholly-owned subsidiaries would, for example, be precluded from undertaking certain reorganizations. For example, paragraph 55(3)(a) and subsections 69(11) and 80.04 each have provisions that are dependent on related or affiliated status.

Recommendation:

We recommend that changes be made to preclude multiple acquisitions of control as a consequence of the controller acquiring *de jure* control or a controller temporarily not satisfying the 75% value test.

We recommend that paragraph 256.1(3)(b) be narrowed in two ways. It should apply only for purposes of the specified provisions and attribute trading restrictions and should not apply to deem the controlled corporation to not be related or affiliated with those corporations controlled by it before the loss restriction event and throughout the period commencing with the loss restriction event during which they are controlled by it.

Subsection 256.1(4)

Subsection 256.1(4) contains rules relevant to the application of subsection 256.1(2). That provision contains the conditions relevant to the application of subsection 256.1(3). One of those conditions is the 75% value test found in paragraph 256.1(2)(a). However, the circumstances in which that condition will be considered satisfied is expanded significantly by virtue of paragraph 256.1(4)(a). Pursuant to that provision, the condition will be satisfied, notwithstanding that the 75% value test is not, if any transaction or event occurs where it is reasonable to conclude that one of the reasons for the transaction or event is to cause a person not to satisfy the 75% value test. Given the consequences of meeting the 75% value test, it is not difficult to imagine circumstances in which other shareholders would enter into transactions or events expressly for the purpose of precluding a particular person with significant equity, but without *de jure* control, from acquiring sufficient shares or rights to acquire shares to satisfy the 75% value test. Thus, a transaction or event to which neither the corporation nor the significant shareholder is a party, or has any influence over or knowledge of, could result in the application of subsection 256.1(3).

Subsection 256.1(3) is an anti-avoidance rule to a number of other anti-avoidance rules in the Act (i.e., the rules that are intended to preclude trading in losses and other tax attributes). The condition for application of that anti-avoidance rule includes a 75% value test, which test takes into account not only the shares owned by the person or group, but also assumes that any paragraph 251(5)(b) rights held by such person or persons in respect of the shares are exercised. In those circumstances, it seems entirely inappropriate to layer on another anti-avoidance rule to in effect dilute the 75% value test, and to thereby erode any otherwise available element of predictability and certainty.

Recommendation:

Amend subsection 256.1(4) by deleting paragraph (a) thereof.