Comments

of

TAX EXECUTIVES INSTITUTE, INC.

on

PENDING CANADIAN INCOME TAX ISSUES

Submitted to

THE DEPARTMENT OF FINANCE

DECEMBER 8, 2010

Tax Executives Institute welcomes the opportunity to present the following comments on income tax issues, which will be discussed with representatives of the Department of Finance during TEI's December 8, 2010, liaison meeting. If you have any questions about these comments, please do not hesitate to call either Rodney C. Bergen, TEI's Vice President for Canadian Affairs, at 604.488.5231, or, Carmine A. Arcari, Chair of the Institute's Canadian Income Tax Committee, at 416.955.7972.

Background

Tax Executives Institute is the preeminent professional organization of business executives who are responsible — in an executive, administrative, or managerial capacity — for the tax affairs of the corporations and other businesses by which they are employed. TEI's nearly 7,000 members represent more than 3,000 of the leading corporations in Canada, the United States, Europe, and Asia.

Canadians make up approximately 10 percent of TEI's membership, with our Canadian members belonging to chapters in Montreal, Toronto, Calgary, and Vancouver, which together make up one of our nine geographic regions. In addition, a substantial number of our U.S., European, and Asian members work for companies with significant Canadian operations. In sum, TEI's membership includes representatives from most major industries, including manufacturing, distributing, wholesaling, and retailing; real estate; transportation; financial; telecommunications; and natural resources (including timber and integrated oil companies). The comments set forth in this submission reflect the views of the Institute as a whole, but more particularly those of our Canadian constituency.

1. Update on Pending Projects and Carryover Issues

a. *Advisory Panel on Canada's System of International Taxation*

In December 2008, the Advisory Panel on Canada's System of International Taxation recommended numerous changes to improve Canada's system for taxing international income and businesses. TEI commends the Department of Finance for undertaking to implement some of those recommendations. What are the next steps in evaluating the current system and responding to the remaining recommendations?

b. *TEI Comments on Salary Deferral Arrangements*

In May 2009 TEI submitted comments recommending changes to the legislation governing salary deferral arrangements (SDAs). (A copy of the letter is attached as Appendix 1.) We invite the Department's reactions to TEI's recommendations and an update on the prospects for changes to the SDA provisions.

c. *Foreign Accrual Property Income (FAPI) on Intercompany Services — Paragraph 95(2)(b)*

Question 6 of the 2008 liaison meeting agenda between the Department and TEI noted that paragraph 95(2)(b) of the *Income Tax Act, Canada* (hereafter, the Act) creates a competitive disadvantage for Canadian-based multinationals with foreign subsidiaries performing services outside Canada for related Canadian companies. In order to be competitive, Canadian multinational companies must be able to respond to the globalization of customer markets and perform many services outside of Canada. If a foreign subsidiary provides services to its Canadian parent (or related Canadian companies), then to the extent that the amounts paid or payable are deductible (or can reasonably be considered to relate to amounts that are deductible) in computing income from a business carried on in Canada, the subsidiary's service fee income may be characterized as FAPI even where the subsidiary is in an active business providing services principally to arm's length parties. Foreign-owned competitors, of course, can deliver services similar to those provided by foreign subsidiaries of Canadian companies without regard to the FAPI rules.

In its 2008 response, the Department of Finance said that the overall objective of this policy is to protect the Canadian tax base, but added that a reexamination of the base-erosion rules would be appropriate in light of the concerns expressed. Would the Department provide an update of its review of the area?

2. Large Corporation Notices of Objection

a. *Objections Invalidated by Reassessments*

Large company tax returns are frequently reassessed multiple times, whether as a result of consequential adjustments arising from other taxation years, completion of specialty audits (*e.g.*, international) after the regular large file audit team has completed its audit, or taxpayer-requested adjustments. Taxpayer objections to earlier reassessments are often still

pending at the time of a subsequent reassessment. Upon reassessment, any previous notice of objection is invalidated and taxpayers must prepare and file a new notice of objection restating all previously pending objections and adding any new objections. It is time consuming for taxpayers to prepare, and for CRA to administer, multiple objections for a taxation year. The requirement to refile objections also increases the risk that taxpayers will miss filing deadlines or make mistakes that limit the amount of potential relief. Would the Department of Finance consider amending the Act to provide that, with respect to each issue for which a valid notice of objection has been filed, the objection stands until the Minister considers the issue and notifies the taxpayer of the Minister's action?

b. *Requirement to State the "Maximum Relief" in Notices of Objection*

Question 3 of the 2008 agenda for the liaison meeting with the Department of Finance noted that, for each issue raised in a Notice of Objection, paragraph 165(1.11)(b) of the Act requires large corporations to specify the amount of relief sought. That provision, together with paragraph 165(1.13)(b), effectively caps the amount of relief available to the taxpayer. Because of the limiting nature of the provisions, taxpayers generally ensure that the relief requested in the Notice of Objection is no less than the maximum potential amount of the reassessment. During the 2008 discussion, TEI recommended that the Department of Finance consider drafting an amendment to the Act that would permit taxpayers to state a reasonable, good faith estimate of the amount of relief sought rather than the maximum amount. TEI noted that, where multiple issues are raised in an objection, the variables involved in the resolution of those issues can interact to produce multiple outcomes. To avoid limiting their relief, taxpayers must always compute and state the most favourable, or highest, amount of relief possible. The Department of Finance said it would consider whether the current rules encourage taxpayers to inflate the amount at risk in order to ensure that the relief sought is not inadvertently restricted. We invite the Department to provide an update on its review and whether a draft amendment might be considered.

3. Functional Currency Reporting Rules

Corporate groups frequently use one entity within the group to borrow for the entire group (either publicly by debt issuance or by private bank loans) and fund affiliates via intercompany loans. Where a Canadian company in the group employs the U.S. dollar as its functional currency, the rules in subsections 261(20) and (21) can produce harsh results. For example, assume a Canadian company (Sub) elects the U.S. dollar as its functional currency and borrows in U.S. dollars from the Canadian dollar functional currency funding company (Fundco). Fundco will be denied deductions for exchange losses on the loan and will likely be taxed on an accrual basis on subsequent gains if exchange rates reverse. If, on the other hand, Sub borrows from Fundco in Canadian dollars any foreign exchange losses Sub incurs on loan repayments would be denied. The technical notes to subsections 261(20) and (21) state that they are intended to prevent *abuses* of the functional currency tax reporting regime. Given that foreign exchange fluctuations are unpredictable, deductions for losses on ordinary intercompany loans should not be considered abusive. Moreover, even the GAAR rules curbing avoidance transactions provide an exception in subsection 245(3) for transactions undertaken "for a *bona fide* purpose and other than for a tax benefit." If subsections 261(20) and (21) are intended to curb abuses, why is there no exception

for nonabusive intercompany loans undertaken for a *bona fide* purpose similar to the GAAR rules? We invite the Department's comments.

4. Foreign Paid-Up Capital

The Department of Finance issued a Comfort Letter (relating to modifications to proposed amendments to subsection 88(3) and paragraph 95(2)(e.1)), dated April 12, 2006, addressing a host of questions about the interpretation and application of various provisions in the Act. The sections addressing the proper computation of foreign paid-up capital have spawned discussion of several ancillary interpretative issues. For example, the commercial law of foreign jurisdictions often requires Canadian foreign affiliates to maintain a minimum ratio of retained earnings to capital. In order to comply with this requirement, foreign affiliates will occasionally, where permitted by local law, apply a current deficit against their capital account, thereby reducing the legal stated capital (*i.e.*, a "Reduction" transaction). Would the Foreign Paid-Up Capital of a particular class of shares of a foreign affiliate be reduced as a result of a Reduction transaction? If the Foreign Paid-Up Capital is reduced, would a foreign affiliate's surplus account be adjusted by a corresponding amount? We invite the Department of Finance's comments.

5. Part VI.1 Tax

Paragraph 110(1)(k) of the Act affords taxpayers a deduction from regular taxable income in order to offset the Part VI.1 tax liability. The policy rationale for the offset is to ensure tax neutrality for profitable taxable Canadian corporations. In July 2010 the Department of Finance released draft legislation with proposed changes to the deduction factor to address the reduction in corporate tax rates. Based on the currently scheduled reductions in the federal and provincial tax rates, however, the new proposed factors do not provide a full offset. For example, on July 1, 2013, an Ontario company's tax rate will be 25 percent. To fully offset the effect of the Part VI.1 tax, the deduction factor should be four times the Part VI.1 tax. Since the proposed factor of 3.5 times for 2011 and subsequent taxation years will not afford taxpayers full offset relief, would the Department consider adjusting the gross-up factor to reflect that the combined corporate federal and provincial income tax rates will be 25 percent in a number of the provinces after 2013?

As an alternative to adjusting the factor for changes in tax rates, the Department could revise the paragraph 110(1)(k) deduction formula to ensure that the tax benefit of the deduction from Part I tax is equal to the amount of Part VI.1 tax paid. Specifically, the Department might consider proposing a deduction formula similar to that accorded under subsection 190.1(3) of the Part VI regime. Such an approach would eliminate the need for adjustments to the paragraph 110(1)(k) deduction as corporate income tax rates decline. We invite the Department's response.

6. Regulation 102

In May 2010, CRA announced several administrative modifications to the Regulation 102 (hereafter "Reg 102") withholding and reporting obligations that will be helpful in simplifying the compliance and administrative burdens for non-resident employees traveling to Canada on short notice. We believe, however that the current legislative framework would support a broader application of treaty-based waivers under Reg 102. For example, the expanded waiver process addresses only non-resident employees who qualify for the $10,000 exemption under Article XV

of the Canada-U.S. Treaty. It is unclear why the waiver process could not be extended to non-resident employees who qualify for the 183-day exemption.

More broadly, under subsection 153(1.1), where the Minister is satisfied that the withholding requirements would create undue hardship, CRA is authorized to reduce the amount of withholding required. The section does *not* state that each individual employee providing services must satisfy the hardship requirement. Instead, the provision could be interpreted to include the significant hardship that employers and the employee group as a whole suffer from multiple payroll withholdings and filings. Employers incur significant costs in withholding and administering the requirements of Reg 102 from the filing of multiple tax returns, to reporting, reconciliation with home-country tax reporting, to recovery of amounts advanced to employees to mitigate excess withholding taxes. Thus, we believe that subsection 153(1.1) can be interpreted to permit CRA to adopt simplified reporting and payment processes such as Employer Reporting and Payment Agreements (similar to those used in the U.K.) or other alternatives as set forth below. In addition, under subsection 220(2.1) the Minister has the authority to waive the requirement for filing of personal tax returns by treaty-exempt individuals. Finally, under subsection 227(8.4) the Minister can collect from the employer any amounts that the employer fails to deduct or withhold from its employees. Other provisions in section 227 permit CRA to assert penalties and interest against the employer to ensure compliance.

Would the Department of Finance engage in a consultative process with TEI and CRA to develop legislative changes to implement a broader, simplified Regulation 102 withholding and reporting regime? Potential alternative regimes to consider are, as follows:

a. *Adopt an Exemption System Similar to the United States.* Under U.S. law, if remuneration earned by a non-resident employee is exempt from U.S. federal income tax pursuant to an income tax treaty, the remuneration is not subject to withholding provided that the employer (the withholding agent) obtains appropriate documentation from the non-resident employee. The employee claims the exemption by providing the employer with a Form 8233, *Exemption from Withholding on Compensation for Independent Personal Services (and Certain Dependent) Personal Services of a Non-resident Alien Individual.*

b. *Annual Treaty-Based Waiver.* CRA should consider permitting an employer to file an annual request for a treaty-based waiver for all employees qualifying for an exemption. The information could be provided by the employer for each qualifying individual. In order to ensure that the tax will ultimately be paid, the employer might be required to provide a lump-sum payroll deposit or a letter of credit. Either would be trued up on expiration of the waiver. The employer would then file an information return for non-resident employees that would include the following information: name, employer, number of days spent in Canada, and the treaty exemption claimed. To reduce the compliance burden, the employer could file this information on one standard form for all employees who performed services in Canada during the calendar year. CRA might also consider waiving the requirement of filing a personal tax return where a treaty-exempt individual satisfies the waiver requirements. Non-treaty-exempt employees would still file a Canadian income tax return.

c. *Adopt an Employer Reporting and Payment Agreement Similar to the United Kingdom.* The requirements of section 151 of the Act could be satisfied by having the employer

provide an Employer Reporting and Payment Agreement similar to those used in the U.K. To ensure payment of the applicable taxes, the employer might be required to provide a letter of credit or make an advance deposit. Where CRA demands a deposit, the employer would have to make an estimate of potential liabilities even though the employer may believe no tax would ultimately be payable for a year. Alternatively, CRA could specify in the Employer Reporting Agreement the dates for filing any reports and remitting the taxes due. The U.K. reporting agreement requires the employer to provide an undertaking to pay the taxes due on behalf of the employee.

We invite the Department's reaction to TEI's alternative proposals as well as the invitation to a joint consultation with CRA to explore developing one of the proposals into draft legislation to ameliorate the current withholding and return filing rules.

7. Interest Rates Applicable to Arrears/Refunds/Excess Cash

One of the findings in the Auditor General's 2009 report was that CRA was holding excess cash deposits and would pay interest at a rate well in excess of the government's cost of funds. TEI agrees with the Auditor General's finding that the government should not pay excessive interest on funds deposited in advance by a taxpayer.

Subsequent to the report, the interest rate on cash refunds was reduced to the 90-day Treasury bill rate. Although TEI agrees that the 90-day Treasury bill rate is the proper rate to apply to funds that are not applied to reassessments issued by CRA, we recommend moving to a three-tier structure for interest rates on deficiencies and refunds, as follows:

1. Consistent with current law, arrears interest on tax deficiencies should be charged at the 90-day Treasury bill rate plus four percent.

2. Where a taxpayer makes an advance deposit to pay a CRA reassessment and some of the reassessed issues are subsequently resolved in the taxpayer's favour, the interest rate on the refunds for issues resolved in the taxpayer's favour should be paid at the previous interest rate, *i.e.*, 90-day Treasury bills plus two percent.

3. For funds on advance deposit that are never applied to fund a CRA reassessment, the interest rate should be set at the 90-day Treasury bill rate.

Discussion: Arrears interest is purposely set at a high level to (1) encourage taxpayers to pay their taxes promptly and (2) discourage taxpayers from treating the government as a lender. The first prong of TEI's proposal retains this feature of current law. At the same time, taxpayers wish to avoid onerous non-deductible arrears interest charges and, consequently, make advance deposits to CRA that CRA applies to reassessments. In order to address the Auditor General's objection to the payment of excess interest, unapplied advance deposits would be subject to the third prong of TEI's proposal. Thus, the recent legislative change reducing the interest rate on refunds to the 90-day Treasury bill rate would effectively be retained.

We believe the intermediate interest rate proposal — the second prong — is necessary to encourage reasonable CRA assessments. Currently, taxpayers are at risk for multiple reassessments on issues and, if they make a cash deposit with CRA in respect of each

reassessment, have no prospect for obtaining a return in excess of the T-bill rate on the cash advanced. Just as the government has no desire to pay an excessive interest rate to taxpayers, taxpayers have no desire to lend to the government where greater returns are available.[1] Thus, where CRA assesses a taxpayer multiple times, some or all of the assessments will be reversed and any cash deposited in respect of the reassessment should be refunded with an appropriate interest rate spread when a reassessment is not sustained.

We believe the proposal levels the playing field by encouraging responsible cash administration by the taxpayer and reasonable reassessments by CRA while responding to the criticisms made by the Auditor General. We invite the Department of Finance's views on TEI's proposal.

8. Risk-of-Litigation Settlements

In previous years, taxpayers and CRA Appeals would settle cases by trading issues, especially where the applicable law was uncertain and subject to differing interpretations or the facts were disputed. This settlement process was beneficial for taxpayers and CRA as a means of resolving disputes, closing cases, and minimizing litigation costs. Regrettably, the Appeals Directorate's policy now requires that all issues be resolved by principles-based settlements. Consequently, CRA Appeals can settle an issue only where there is a clear factual and legal basis for resolving the matter. Thus, negotiation or trading of issues based on risks of litigation is not permitted.

Although a principle-based settlement approach may be theoretically preferred, as a practical matter it is often cost prohibitive for taxpayers (and the government) to establish facts to an absolute certainty in litigation, especially for smaller assessment issues. As important, many provisions in the Act and the regulations require judgment and interpretation because their application to any particular facts is not black and white. External litigation fees for business taxpayers can easily range from $500,000 to $1 million per issue. In addition, internal overhead costs to support the litigation are also significant. The resource demands upon CRA, the Department of Justice, and the Department of Finance in support of tax litigation are likely comparable to those incurred by taxpayers.

In order to reduce the number of issues and cases that are being litigated, TEI recommends empowering the CRA Appeals Directorate to settle and offset assessment issues based on an analysis of the risks of litigation. Implementing such an approach would permit CRA and taxpayers to resolve disputes using the same "hazards of litigation" approach effectively utilized by U.S. taxpayers to reduce the number of controversies proceeding to the courts. We invite the Department of Finance's views on TEI's recommendation.

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[1] In TEI's proposal, interest would only be paid from the later of the date of the reassessment or the date the cash is put on deposit. Thus, refund interest would not be triggered unless CRA issues a reassessment and the taxpayer applies an advance deposit on that reassessment.

9. Taxpayer Requests for Determinations of ACB and Other Amounts

Subsection 152(1.1) of the Act provides

> [w]here the Minister ascertains the amount of a taxpayer's non-capital loss, net capital loss, . . . for a taxation year and the taxpayer has not reported that amount as such a loss in the taxpayer's return of income for the year, the Minister shall, at the request of the taxpayer, determine, with all due dispatch, the amount of the loss and shall send a notice of loss determination to the person by whom the return was filed.

Subsection 152(1.2) permits a taxpayer to object to and appeal the Minister's loss determination under subsection 152(1.1). Subject to the taxpayer's appeal or a redetermination by the Minister, subsection 152(1.3) provides that, the loss determination is binding on both the Minister and the taxpayer for the purpose of calculating the taxable income or tax of the taxpayer for any year.

Would the Department of Finance consider proposing new administrative provisions — similar to the loss determination provisions under subsections 152 — to allow a taxpayer to obtain a binding determination in respect of the Adjusted Cost Base (ACB) of a significant capital property without an actual or deemed disposition of that property? Similarly, would the Department consider creating an administrative provision permitting the determination of the amount of a corporation's "Safe Income"?[2]

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[2] TEI is proposing administrative processes to enable a taxpayer to obtain a binding determination of ACB and Safe Income for the following reasons:

ACB of a particular capital property

The ACB of a significant capital property has material tax and financial reporting implications for the property's owner. Because of the numerous adjustments required under section 53, the determination of the ACB of certain capital property (*e.g.*, corporate shares or an interest in a partnership) requires a significant amount of time, effort, and expertise, especially where unusual transactions (*e.g.*, reorganizations) have occurred or tax elections have been made. The longer a taxpayer owns a particular property, the more challenging and time-consuming the taxpayer's determination of, and CRA's audit of, the ACB since the relevant documents and information may become unavailable because of changes in personnel or the entity involved. In addition, when a capital property is transferred, the transferor's ACB in the property often becomes the transferee's ACB under various deeming rules and tax elections. Prior to any such transfer, the transferor and the transferee will want to be certain of the ACB of the property since it may affect the terms of the transfer agreement. Finally, the ACB of a property is important in planning for its disposal. Indeed, in some cases a taxpayer needs certainty about the ACB of a particular capital property even where a property is not being disposed. For example, following an acquisition of control of a corporation, the acquired corporate entity must comply with subsection 111(4) of the Act.

Safe Income of a particular corporation at a particular time

The "Safe Income" of a particular corporation is very important in planning for certain transactions or a series of transactions (including corporate distributions and reorganizations) that involve a past, present, or future disposition of all or part of the shares. Part or all of a dividend or deemed dividend received by a Canadian resident corporate shareholder from a particular corporation may be recharacterized under subsection 55(2) as capital gain taxable to the shareholder to the extent that the dividend income exceeds the shareholder's share of the Safe Income of the corporation. (Footnote continues . . . .)

10. Specified Energy Property Rules

The government has undertaken various tax and non-tax initiatives to encourage investments in projects producing clean energy, such as wind and solar power generation. Income Tax Regulation 1100(25), however, impedes investments in such ventures by Canadian businesses that are structured as tiered partnerships. Specifically, the exceptions to the restrictions on Capital Cost Allowances (CCA) in Regulation 1100(26) are not available where the investor is a partnership investing in another partnership that holds the underlying clean-energy project's assets. As a result, a partnership entity competing with a corporation to bid on a project (*e.g.,* a wind farm under construction in Ontario that is held by a partnership) is at a competitive disadvantage. In addition, because of commercial issues or regulatory restrictions that make a purchase of the underlying assets infeasible, there is frequently no avenue for structuring the purchase other than to acquire a partnership interest. We recommend that the Department of Finance review Income Tax Regulation 1100(26)(b) with a view of broadening the exceptions to the restrictions on CCA claims. Such a step would facilitate investments by partnership investors where the ultimate owners of the partnership are principal-business corporations. We invite the Department's reaction and comments.

11. Proposed Subsection 220(2.1)

Subsection 220(2.1) of the Act generally accords the Minister of Revenue discretion to waive the requirement to file a prescribed form, receipt, or document, or to provide information. Proposed subsection 220(2.2), however, would preclude the Minister from exercising that discretion for forms or information filed on or after the day specified in paragraph (m) of the definition of "investment tax credits" (ITC) in subsection 127(9). As a result, the forms and information supporting a claim for investment credits must be filed within 12 months of the due date prescribed for filing the taxpayer's income tax return. The proposed subsection would apply to any form or information that should have been filed by November 16, 2005.

CRA generally conducts income tax audits of a corporation's taxation year well after the end of the 12-month deadline for filing ITC claims. If certain expenditures are reclassified from operating expenses or intangible costs (such as Canadian Development Expense or Canadian Exploration Expenditures) to class 41 assets, the reclassified expenditures would be considered "qualified property" for ITC purposes. TEI believes the reclassified expenditures should be eligible for ITC notwithstanding that the 12-month deadline for including the information on the prescribed form may have passed.

Would the Department of Finance consider clarifying that the proposed subsection does not apply in respect of a form, receipt, document or information relating to claims under paragraph (m) of the definition ITC in subsection 127(9) where the omission of the eligible expenditures

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As with the determination of ACB, the determination of the Safe Income of a corporation generally requires significant time, effort, and expertise, especially when unusual items "could reasonably be considered to be attributable to anything other than income earned or realized by any corporation after 1971." It is usually more difficult and time consuming for a taxpayer to determine, and for CRA to audit, the Safe Income of a particular corporation after the corporation has active business activities for many years because the relevant documents and information may become unavailable due to changes in personnel or because the corporation may cease to exist.

from a form due within 12 months after the tax return filing date is because of a reclassification on audit?

Conclusion

Tax Executives Institute appreciates the opportunity to present its comments in respect of pending income tax issues. We look forward to discussing our views with you during the Institute's December 8, 2010, liaison meeting.

Respectfully submitted,

Tax Executives Institute, Inc.

By:

Paul O'Connor
International President

Tax Executives Institute, Inc.

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Barcardi-Martini BV
Geneva, Switzerland
Timothy J. McCormally
Executive Director
Eli J. Dicker
Chief Tax Counsel
Mary Lou Fahey
General Counsel

May 4, 2009

Please Respond To:

Ms. Sherrie Ann Pollock
Head, Taxation
RBC Dexia Investor Services
77 King Street W., 35th Floor
Toronto, ON M5K 1K5
416.955.7373

Mr. Brian Ernewein
General Director
Tax Policy Division
Department of Finance
140 O'Connor Street
Ottawa, ON K1A 0G5
Canada

Re: *Salary Deferral Arrangement Legislation*

Dear Mr. Ernewein:

The Salary Deferral Arrangement (SDA) legislation was enacted more than 20 years ago in order to prevent abuses of the employee benefit plan (EBP) rules by non-taxable employers. While the purpose of the SDA rules is targeted, in application the rules have been applied broadly and impede the development of effective, modern long-term incentive compensation (LTIC) packages that taxable Canadian corporations must offer to attract and retain talented employees. On behalf of Tax Executives Institute, I write to propose changes to the SDA rules that will narrow their scope without undermining their efficacy in preventing excessive accumulations of retirement income by employees of non-taxable employers.

Background

Tax Executives Institute is the preeminent association of business tax executives. The Institute's 7,000 professionals manage the tax affairs of 3,200 of the leading companies in Canada, the United States, Asia, and Europe and must contend daily with the planning and compliance aspects of Canada's business tax laws. Canadians make up 10 percent of TEI's membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver, which together make up one of our nine geographic regions. Our non-Canadian members (including those in Europe and Asia) work for companies with substantial activities in Canada. In sum, TEI's membership includes representa-

1200 G Street, N.W., Suite 300 • Washington, D.C. 20005-3814 • P: 202.638.5601 | F: 202.638.5607

tives from most major industries including manufacturing, distributing, wholesaling, and retailing real estate; transportation; financial services; telecommunications; and natural resources (including timber and integrated oil companies). TEI is concerned with issues of tax policy and administration and is dedicated to working with government agencies to reduce the costs and burdens of tax compliance and administration to our common benefit.

Evolution of Compensation Practices
Enhances Long-Term Employee Retention

Corporate compensation programs have changed substantially since the SDA rules were adopted in 1986. Then, most compensation programs consisted of a salary, an incentive-based cash bonus, and, as a long-term incentive, ordinary stock options. Over time, employers have complemented these programs by instituting innovative LTIC programs to attract and retain talented employees on a long-term basis.

The longer the rewards under an LTIC program are deferred, the greater the incentive for employees to remain with the employer and the better the employer can align shareholder and employee interests. Moreover, because of (1) concerns in the capital markets about the leveraging and dilutive effects of employee stock options on existing shareholders and (2) recent changes in the accounting for stock options, employers have reduced the use of ordinary stock option grants in favor of LTIC programs, especially those utilizing full-value equity instruments.[3] Thus, LTIC programs are increasingly based on restricted stock, restricted stock options, restricted stock units, phantom stock, and tandem programs with multiple incentives. To be effective as an incentive for long-term performance, these plans must be structured for periods longer than three years but the interpretation of the SDA rules inhibits this.

SDA Rules

Under subsection 248(1) of the *Income Tax Act, Canada*, an SDA is any arrangement, whether funded or unfunded, under which a person has the right in a taxation year to receive an amount after the year where it is reasonable to consider that *one* of the main purposes for the creation or existence of the right *is to postpone tax* payable under the Tax Act by the taxpayer in respect of salary or wages for services rendered by the taxpayer in the year or a preceding year. (Emphasis added.) An exception under paragraph (k) of the definition of Salary Deferral Arrangement in subsection 248(1) permits an employee to defer income for up to three years after the year in which the services are performed.

The current SDA rules are essentially unchanged since their adoption more than two decades ago. The government first identified a concern with respect to how certain deferred compensation arrangements were structured under the EBP rules in 1984, describing the issue, as follows:

> These plans have created an unintended tax deferral opportunity for employees of *non-taxable or non-profit employers* who are unconcerned by the question of deductibility.

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[3] A "full-value" equity instrument is any form of compensation that, once vested, will be based upon the full value of the underlying company shares. In a stock option or stock appreciation rights (SAR) plan, the recipient benefits from the *appreciation* in value of the underlying stock subsequent to the grant. In other words, for an SAR or a stock option plan to have value, the price of the underlying stock must rise and stay above the exercise price. By contrast, in a "full-value" incentive plan, unless the stock's value plummets to zero, the equity instrument will always have some value to the recipient upon the lapse of a vesting period or other plan restriction.

> A non-taxable employer, such as one in the public sector, can establish and maintain an EBP providing employees with essentially the same tax deferral benefits as a [registered pension plan, registered retirement savings plan, or deferred profit sharing plan] but not subject to any deduction limits.[4]

In effect, non-taxable employers were using EBPs to provide a tax-free accumulation of retirement income in excess of established retirement deduction limits. To curb that practice, the government explained the proposed SDA rules' purpose, as follows:

> As noted in the May 1985 budget, the government is concerned that employee benefit plans can offer unintended tax deferral advantages to certain groups of employees . . . .
>
> Where the employer is non-taxable, there is no cost to it of entering into an arrangement to permit the employee to defer tax on employment income . . . .
>
> The government is concerned about the implications of such plans for government revenues and the unfair distribution of tax benefits to individuals in different employment situations. The budget proposes a measure designed to prevent this deferral of salary for tax purposes without interfering with other arrangements where employee benefit plans are not primarily motivated by tax deferral considerations.[5]

Despite the government's express concern about the perceived abuse of EBPs by non-taxable employers, the legislation is not limited to such employers. Indeed, the statute is broadly worded. It permits all forms of salary deferral arrangements, whether tax-motivated or not, as long as the deferral period is limited to three years. For plans with deferral periods longer than three years, the provision incorporates a purpose test applicable to *all* entities — taxable or not — as well as *all* forms of deferred compensation — funded or unfunded. The SDA rules are not, however, intended to apply to "arrangements where employee benefit plans *are not primarily motivated by tax deferral considerations*."[6]

Within months of adopting the SDA rules, the government proposed the Retirement Compensation Arrangement (RCA) rules as "new anti-avoidance rules aimed at arrangements entered into to postpone unduly the tax on salary or wages . . . ."[7] The press release introducing the

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[4] *See Building Better Pensions for Canadians – Improved Tax Assistance for Retirement Saving,* Department of Finance (February 1984), at 12 (Emphasis added).

[5] *See Securing Economic Renewal – Federal Budget Papers,* Department of Finance (February 26, 1986), at 35-36. *See also Securing Economic Renewal – Federal Budget Papers* (May 23, 1985), at 56.

[6] *Securing Economic Renewal – Federal Budget Papers,* Department of Finance (February 26, 1986), at 36 (Emphasis added).

[7] *See A Better Pension System—Saving for Retirement, Improved Tax Treatment: Detailed Rules and Procedures,* Department of Finance (October 1986). "The February 26, 1986 budget proposed new anti-avoidance rules aimed at arrangements entered into to postpone unduly the tax on salary or wages . . . . The existing rules relating to employee benefit plans permit the deferral of tax on certain pension and retirement arrangements that are not registered. These plans are generally referred to as "off-side" pension plans and can be used to circumvent the limits on tax assistance

proposed RCA rules describes the notion of "off side" or "non-statutory" retirement plans, implying that such plans differ from the deferred compensation arrangements the SDA rules were implemented to address.[8] The language in the press release announcing the draft RCA legislation, however, is strikingly similar to the language in the 1984 publication *Building Better Pensions for Canadians,* which provided the background and rationale for adoption of the SDA rules in the 1986 budget. Indeed, one commentator attributes the RCA rules directly to the perceived abuse identified in the government's 1984 policy paper:

> The Part XI.3 refundable tax was introduced for the purpose of countering the perceived abuse of the employee benefit plan rules by tax-exempt or other non-taxable employers who provided for deferred tax on retirement benefits without being concerned with the deductibility thereof, deferred or otherwise . . . . The system is therefore designed to prevent the tax-free accumulation of retirement income for the benefit of the employee by levying an advance refundable tax of 50 per cent of contributions and earnings.[9]

Thus, with respect to funded plans, the RCA rules implemented in 1987 effectively address the same deferred compensation arrangements articulated in 1984 that led to the SDA rules. In addition, the government subsequently introduced the specified retirement arrangement (SRA) rules in 1992 to ensure that the amount of RRSP "room" of employees of tax-exempt entities is reduced where the employees are entitled to pension benefits under an unfunded or partially funded and unregistered plan.[10] On a combined basis, the SDA rules substantially overlap the RCA and SRA rules.

In light of that overlap, as well as the evolution of corporate compensation practices since 1986, we believe the purpose and effects of the SDA rules should be re-examined for non-exempt entities.

Discussion

U.S.-based employers are increasingly using full-value share vehicles such as restricted stock and restricted stock units (payable in cash or stock at the employee's election) in their LTIC plans.[11] To satisfy the employers' long-term compensation objectives, three to five years of service

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provided with respect to RPPs and other statutory plans such as RRSPs and DPSPs. Off-side pension plans are utilized . . . by employees of non-taxable entities. New rules are proposed for retirement compensation arrangements that are designed to remove the tax benefits flowing from the use of off-side plans."

[8] *See Department of Finance Press Release* (March 27, 1987).

[9] Canada Tax Service — McCarthy Tétrault Analysis, 207.5-207.7 — *Tax in respect of Retirement Compensation Arrangements.*

[10] For the SRA rules, *see* section 8308.3 of the Income Tax Regulations.

[11] The trend toward the use of full-value share plans instead of options was accelerated by the revision of the financial accounting treatment of options under FAS 123(R). *See Current Trends in Executive Compensation*, Culpepper Compensation & Benefits Surveys (September 12, 2006). *See also Equity Compensation Continues Shift Towards Restricted and Performance-Based Stock,* Culpepper Compensation & Benefits Surveys (March 9, 2006).

generally required for vesting, with some plans having deferral periods up to ten years.[12] Because of the uncertainty under the SDA rules, such LTIC plans must be adapted for use in Canada.

One major obstacle for taxable Canadian corporations is that Canada Revenue Agency (CRA) interprets the "purpose" test of the SDA rules very broadly. CRA nearly always finds that a full-value plan has *a* tax deferral purpose whenever the deferral period is longer than three years even where the plan is *not* structured or motivated by tax deferral considerations.[13] In effect, CRA's rulings focus on the *characteristics* or *outcome* of the plan rather than on the *purpose* of the plan. Indeed, in response to a request to issue guidelines describing when a "purpose" would be found the Agency stated, "Because of the wide variety of arrangements . . . we have not been able to formalize general guidelines as to what will, or will not, be evidence of 'purpose' or as to the difference between 'purpose' and 'main purpose.'"[14] More than 20 years have elapsed since CRA's initial statement and no additional guidance has been promulgated with respect to the purpose test. As important, no consensus has emerged among practitioners about how to design a plan that complies with it. Consequently, Canadian LTIC plan designers stay within the three-year safe-harbour rule of paragraph (k) in the definition of an SDA in subsection 248(1).

The three-year rule, however, frustrates employers' objectives of establishing a *long-term* incentive plan. In today's global economy, the use of full-value share vehicles with vesting provisions longer than three years is necessary to (1) attract and retain the most talented individuals and (2) align the long-term interests of those key employees with shareholders. As a result, Canadian employers are at a competitive disadvantage with those in the United States that are afforded more scope in their plan designs.

To ensure that the Canadian tax treatment of LTIC plans is competitive with the United States while preserving administrable and consistent tax policy rules for the treatment of such plans, we suggest that the Department of Finance consider introducing changes to the SDA legislation or the Income Tax Regulations. Specifically, consistent with the legislative background of the SDA provision (discussed above and cited in footnotes two through four), we suggest the following alternatives:

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[12] In the United States, deferred compensation is generally governed by Internal Revenue Code section 409A. Under those rules, U.S. employers are not restricted in the amount, form, instrument, calculation method, or duration of the deferred compensation. Instead, the rules prescribe the time for making deferral elections and generally restrict the employees' ability to make subsequent changes.

[13] Several interpretations acknowledge that deferred compensation payable more than three years from the date the services are performed may be in the form of a restricted stock unit, but the amount to be paid must be limited to the appreciation in the value of the underlying equity unit subsequent to the date of grant. *See, e.g.,* Technical Interpretation 2003-0001905—*Restricted stock units salary deferral arrangement rules* (April 15, 2003). Other interpretations require the amount paid beyond the three-year period to be totally dependent on future earnings events. *See, e.g.*, Technical Interpretation 2000-0056537—*Salary deferral arrangement incentive based on future earnings* (November 24, 2000).

[14] *See Revenue Canada Roundtable, Q.27 Main Purpose of Postponing Tax Payable,* REPORT OF THE PROCEEDINGS OF THE FORTIETH TAX CONFERENCE (1988 Canadian Tax Foundation Meeting), at 53:44-45.

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- limit the rules to *tax-exempt* employers. (Employers that pay income tax under statutes such as the *Ontario Electricity Act, 1998*, and similar provincial legislation should *not* be considered tax exempt).

- prescribe conditions under which an SDA will be deemed not to violate the purpose test. For example, the purpose test might be limited to situations where tax symmetry is not maintained between a non-exempt employer's deduction and the employee's income inclusion. So long as a plan is unfunded and no cash or benefit is transferred to the employee, there would seem to be no tax policy reason for accelerating both the employer's deduction and the employee's income inclusion simply because the incentive period exceeds an arbitrary three-year limit.[15]

TEI urges the Department of Finance to revisit the SDA rules to clearly delineate the tax policy differences between acceptable and unacceptable deferred compensation programs, especially where the "purpose" test might apply. We submit that a three-year period is too abbreviated to permit employers to build effective, long-term incentive plans that encourage employee retention and long-term performance. If an indefinite deferral period is not possible, we recommend that the Department consider providing a 10-year limit on LTIC plans. We would appreciate an opportunity to meet with representatives of the Department of Finance in order to discuss our recommendations and proposals.

Conclusion

TEI's comments were prepared under the aegis of the Institute's Canadian Income Tax Committee, whose Chair is Rod Bergen. If you should have any questions about the recommendations, please do not hesitate to call Mr. Bergen at 604.488.5231 (or Bergen@jp-group.com) or Sherrie Ann Pollock, TEI's Vice President for Canadian Affairs, at 416.955.7373 (or sherrieann.pollock@rbcdexia.com).

Respectfully submitted,

Tax Executives Institute

Vincent Alicandri
International President

cc: Gérard Lalonde, Director, Tax Legislation Division
Alexandra MacLean, Chief, Deferred Income Plans
Wayne Adams, Director General, Income Tax Rulings Directorate
Sherrie Ann Pollock, 2008-2009 Vice President for Canadian Affairs
Rod Bergen, 2008-2009 Chair of TEI's Canadian Income Tax Committee

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[15] As a result of the accelerated income inclusion the employee will bear a significant cash tax burden before any cash is available to pay the tax. The employer receives an immediate tax deduction pursuant to paragraphs 20(1)(oo) or 20(1)(pp) of the Act even though no cash outlay or payment may be made for several years, which is a notable exception to the 180-day rule in subsection 78(4) of the Act for deducting accrued but unpaid compensation.