TAX EXECUTIVES INSTITUTE, INC.

INCOME TAX QUESTIONS

Submitted to

DEPARTMENT OF FINANCE

DECEMBER 6, 2017

Tax Executives Institute Inc. ("TEI" or the "Institute") welcomes the opportunity to present the following comments and questions on income tax matters, which will be discussed with representatives of the Department of Finance during our liaison meeting on December 6, 2017. Should you have any questions about the agenda in advance of the meeting, please do not hesitate to contact Fraser E. Reid, TEI's Vice President for Canadian Affairs, at (604) 609-2956, or Paul T. Magrath, Chair of TEI's Canadian Income Tax Committee, at (905) 944-5000, extension 7264.

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A. Legislative Update and Tax Policy Discussion

1. *Legislative Priorities*

TEI invites an update regarding the Department of Finance's legislative priorities for the coming months. In addition, TEI would appreciate an update with respect to the Organization for Economic Co-operation and Development ("OECD") Base Erosion and Profit Shifting ("BEPS") project and any plans the Department of Finance may have regarding the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*.

2. *Tax Policy Discussion*

The following questions are intended to raise broader questions of tax policy on a discussion basis. All discussions are conducted under the Chatham House Rule, whereby participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.

a) Tax Competitiveness

TEI members are concerned with the competitiveness of the Canadian tax system viewed in its entirety, i.e., the combined economic effect of commodity taxes, corporate income taxes, and personal income taxes. The combined tax burden faced by Canadian residents adversely impacts the ability of large business taxpayers, particularly multinational companies, to attract and retain skilled individuals.

For a long time, the Canadian tax system could be seen as aspiring to achieve a national harmonized sales tax ("HST"), a broad-based, low-rate harmonized corporate income tax regime (i.e., a 25-percent rate comprising a 15-percent federal rate and a 10-percent provincial rate), and a personal income tax system the top marginal rate of which could be considered competitive with that in the United States, but which applies at a much lower income level.

Recently, however, there has been more talk of tax incentives (base narrowing), and the small business deduction and income sprinkling debate has taken on a life of its own. At the same time, top marginal personal income tax rates are up and exceed 50 percent in most of the major provinces, while statistics for the 2015 taxation year show an average effective tax rate among top individual earners of 29 percent.

What are the optimum rates for Canadian corporate and personal income taxes? Capital is very mobile, and responds to lower tax rates. Individuals are perhaps less mobile, but not immune to financial incentives. Did the 2016 introduction of a 33-percent tax bracket yield the $3 billion that was anticipated at the time of its proposal?

Already, the top 10 percent of income earners pay nearly 50 percent of Canada's personal taxes. Does the Department of Finance have a target fair tax burden in mind for high-income Canadians? What role does competiveness play in setting the highest marginal tax rates on individuals?

b) Anti-Avoidance Drafting

Rightly or wrongly, there is a perception amongst tax advisors that the Government of Canada is prepared to pass broadly phrased anti-avoidance rules (perhaps referring to "one of the purposes") and rely on tax administrators to exercise appropriate discretion in applying them.

This approach is troubling to TEI members because it would rely heavily on the judgment of individual revenue agents who may perceive their mandate as applying the rules to raise revenue, without regard to the restraint they might be expected to exercise. Indeed, anti-avoidance rules conferring this much discretion invite individuals to apply their own personal values in determining a taxpayer's "fair share" of taxes owed, rather than applying the enacted tax law to make that determination. In a perfect world, any misapplication of the subjective rules at the front lines would be corrected through oversight and referral within the Canada Revenue Agency ("CRA"). But the level of district office independence swings like a pendulum, and senior CRA officials are not always willing to examine and overturn field decisions based on a belief that the CRA enforces the law and the taxpayer has recourse to the courts when an auditor misinterprets the law.

With this background, we invite discussion of the Department of Finance's position on broadly phrased anti-avoidance rules and, if such rules are enacted in Canada, the checks that would be available to ensure that broadly worded and inherently subjective rules are applied in a way that respects public policies other than government revenue maximization.

B. Carryover Matters and Follow-up Questions

1. *Interpretation of the 90-day Rule in Regulation 5901(2)(a)*[1]

This question follows up on question C.7 from our 2016 liaison meeting. In that meeting, the Department of Finance indicated its desire to discuss with the CRA the manner in which the CRA has interpreted and applied this provision prior to concluding whether a legislative amendment is warranted. TEI would like to understand if there have been any developments regarding this matter.

For ease of reference, the 2016 question and draft response are reproduced in the Appendix.

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[1] Unless otherwise indicated, all references to "Regulation" or "Reg." herein are to sections, subsections, or paragraphs of the federal *Income Tax Regulations*, R.S.C., c. 945.

2. *T4 Reporting and Regulation 102*

This question follows up on question C.8 from our 2016 liaison meeting. The Department of Finance indicated that it would follow up with the CRA to obtain a more current view of the matter. TEI would like to understand if there have been any developments regarding this matter.

For ease of reference, an abbreviated version of the 2016 question and the draft response are reproduced in the Appendix.

3. *Part VI.1 Tax and Paragraph 110(1)(k)*

Paragraph 110(1)(k) of the Income Tax Act affords taxpayers a deduction from regular taxable income to offset the Part VI.1 tax liability.[2] The policy rationale for this offset is to ensure tax neutrality for profitable, taxable Canadian corporations. However, the deduction factor in paragraph 110(1)(k), which was last amended for taxation years ending after 2011, does not provide a full offset and thus falls short of the policy objective. For example, an Ontario company's tax rate is 26.5 percent, but the factor of 3.5 assumes a corporate tax rate of 28.5 percent.[3] To fully offset the Part VI.1 tax, the deduction factor should be approximately 3.8 times the Part VI.1 tax. Consequently, for every $1,000 of dividends paid, a taxpayer based in Ontario is out of pocket $29 for what is intended to be a tax-neutral regime.

During our 2014 liaison meeting, TEI urged the Department of Finance to consider adjusting the deduction factor to 3.8. The response at that time was that reviewing the factor would be considered only if all of the provinces moved to a uniform lower corporate income tax rate. Given the passage of time and the fact that there is little indication that the provinces will move to a uniform lower rate, would the Department of Finance reconsider its position?

C. New Matters

1. *Part XIII Tax*

Part XIII tax applies where a resident of Canada pays or credits a certain amount to a non-resident, requiring the Canadian resident to withhold and remit a 25-percent tax on amounts so paid or credited, unless that rate is reduced by an income tax treaty between Canada and the country of which the payee is a resident. Acceptance by the Minister of Finance (the "Minister") of the withholding tax amount and the subsequent reporting of that amount on Schedule 29 of

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[2] Unless otherwise indicated, all references to "section," "subsection," or "paragraph" herein are to sections, subsections, or paragraphs of the federal *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended (the "Act").

[3] The 3.5 factor assumes a provincial rate of 13.5 percent. With the exception of the Atlantic provinces that have rates of 14–16 percent, the provincial rates range between 11 percent and 12 percent.

an income tax return or receipt of the required NR4 notification does not trigger the commencement of a period to which a statute of limitations would apply.

Where the Canadian resident does not withhold and remit tax as required, the Canadian resident is liable for the unremitted withholding tax pursuant to subsection 215(6). Furthermore, subsection 227(10) provides that the Minister "may" assess the Canadian resident "at any time" an amount payable under Part XIII. Once an assessment is raised, Divisions I and J of Part I of the Act will apply, and with this assessment issued, section 152 will cause the normal reassessment period under subsection 152(3.1) to apply. Accordingly, amounts paid or credited under Part XIII by the Canadian resident on behalf of the non-resident payee are not regularly assessed and, therefore, the normal reassessment period never begins to run.

Under the Act, the term "assessment" means the determination by the Minister of the amount of a person's tax liability. The Minister is required to examine the taxpayer's return of income for the taxation year and assess tax for the year "with all due dispatch" or "within a reasonable time." Given that a Canadian resident is liable for any tax amounts determined under Part XIII, it is not reasonable that the Minister does not have an obligation to raise an assessment related to a Part XIII tax liability, regardless of whether the Minister agrees with the amount of tax withheld and remitted. The word "may" in subsection 227(10) allows the Minister to forego making a formal assessment in respect of any Part XIII tax liability. The Minister has full discretion not to assess tax unless the Minister determines that, upon review of the facts and the application of the law, an additional liability of tax is due. This is the only time when the Minister has a statutory duty to assess a Part XIII tax liability that would be subject to the normal reassessment period provided in subsection 152(3.1).

We request that the Minister be required by statute to issue an initial assessment for a Part XIII tax liability and be subject to the normal reassessment period under subsection 152(3.1). A Part XIII tax liability should be treated no differently than a Part I tax liability, which the Minister is required to assess "with all due dispatch" or "within a reasonable time." As an administrative solution, the assessment process could be handled efficiently through Schedule 29 reporting on Form T2 and the Minister's assessment could also encompass any Part XIII tax liability.

Without the Minister having an assessment obligation, tax liability under Part XIII can lead to tax uncertainty as well as possible inefficient and lengthy audit cycles. We welcome the Department of Finance's views on this proposal.

2. *Short-form vs. Long-form Amalgamation in Bump Context*

In determining whether property is eligible for the increase in cost pursuant to paragraph 88(1)(d) (the "Bump"), it is often necessary to review all property acquired in the series of transactions that includes the acquisition of control and the combination of the parent and subsidiary corporations. In a short-form amalgamation, no shares are issued to the parent corporation. In a long-form amalgamation under the Canada Business Corporations Act, it

would appear that the parent corporation's shareholders may be viewed as acquiring new shares of the parent.

In policy terms, TEI does not believe that the issuance of new shares should result in a different analysis in reviewing all of the properties acquired in the series of transactions. However, due to the complexities of a Bump analysis, the issuance of the shares to the parent corporation presents an additional amount of work and could lead to some uncertainties.

We request that the Department of Finance consider a legislative change to ensure that any shares of the parent corporation acquired solely because a long-form amalgamation was undertaken instead of a short-form amalgamation are not considered as "property acquired" for purposes of the Bump analysis.

3. *Withholding of Tax on Donation of Shares Acquired Through Stock Option Exercises*

The following question is being asked of the CRA in connection with our December 5, 2017, liaison meeting with CRA representatives. If the CRA is ultimately unwilling to provide the administrative concession described in the question below, would the Department of Finance be willing to consider a legislative amendment to the same effect?

> **Question 1.** *Withholding of Tax on Donation of Shares Acquired Through Stock Option Exercises*
>
> An employer is generally required to withhold and remit tax on stock option benefits realized by an employee to the same extent as if the amount of the benefit had been paid to the employee as a cash bonus. However, an employer's withholding and remittance obligations do not generally extend to any portion of the benefit that is deductible by the employee under paragraph 110(1)(d) or under subsection 110(2.1). Subsection 153(1.01) expressly permits these two tax withholding exemptions.
>
> With respect to the tax withholding exemption under subsection 110(2.1), upon the exercise of employee stock options, if the employee directs an employer-approved broker or dealer to immediately sell the shares and donate all or part of the proceeds to a qualifying charity, subsection 110(2.1) may entitle the employee to claim a tax deduction under paragraph 110(1)(d.01) proportionate to the amount of the donated proceeds. Unlike the case where shares are donated, subsection 153(1.01) specifically provides that the amount determined under paragraph 110(2.1)(b) to be deductible under paragraph 110(1)(d.01) will reduce the amount of the stock option benefit subject to withholding. In other words, the employer would not be required to withhold and remit tax on the portion of the cash proceeds donated to charity.

Under paragraph 110(1)(d.01), if an employee donates shares acquired in the exercise of employee stock options during the year, the shares are acquired and within 30 days of exercising the option, the employee is generally entitled to an additional tax deduction in an amount equal to one-half of the stock option benefit realized. Unlike the case where share sale proceeds are donated by an employer-appointed broker, subsection 153(1.01) does not explicitly provide for an employer withholding tax exemption in cases where after exercising options to acquire shares, the employee donates the acquired shares to a charity; technically speaking, withholding tax in respect of the stock option benefit realized on the exercise must still be collected and remitted.

In cases where an employer facilitates the donation of an employee's shares acquired upon the exercise of employee stock options by transferring such shares to a charity selected by the employee, would the CRA be open to providing an administrative concession whereby the employer could reduce the stock option benefit subject to withholding by an additional 50-percent deduction available under paragraph 110(1)(d.01)?

4. *Interest Rates on Tax Debts and Tax Refunds*

Interest rates on the tax debts of corporations are currently 500 percent of the interest rates on tax refunds. This has been the case for all but one quarter since the third quarter of 2010.

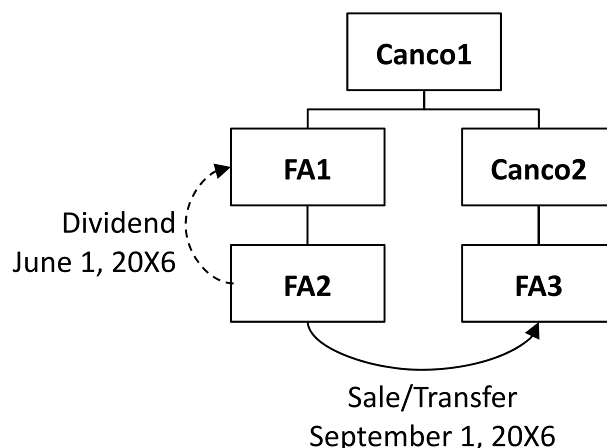
TEI requests that the Department of Finance consider narrowing this difference.

APPENDIX
Questions and Draft Responses from November 16, 2016, Liaison Meeting

1. *Interpretation of the 90-day rule in Reg. 5901(2)(a)*

This question requests clarification on the application of Reg. 5901(2)(a) in similar fact patterns that creates ambiguity under current interpretation. Consider the following two scenarios:

a) Scenario A



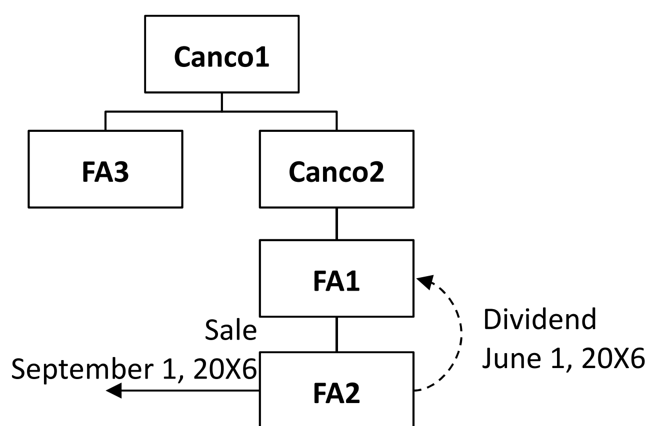
i. FA2 is a non-resident corporation and a wholly owned subsidiary of FA1.
ii. FA2 carries on an active business in a Tax Information Exchange Agreement jurisdiction.
iii. FA1 is a non-resident corporation and a wholly owned subsidiary of Canco1, a corporation resident in Canada.
iv. FA1 is a holding company resident in a Designated Treaty Country ("DTC").
v. FA1 and FA2 are both "foreign affiliates" of Canco1.
vi. FA1 and FA2 both have taxation years ending December 31, 20X5.
vii. The shares of FA2 qualify as excluded property.
viii. FA3 is a wholly owned foreign subsidiary of Canco2 and resident in a DTC.
ix. Canco2 is a corporation resident in Canada and a wholly owned subsidiary of Canco1.
x. On June 1, 20X6 (more than 90 days after the start of its taxation year), FA2 pays a whole dividend to FA1. FA2 does not have sufficient surplus at the particular time for the whole dividend to be considered paid out of surplus such that, absent the 90-day rule in Reg. 5901(2)(a), a portion of the whole dividend would be deemed to be paid out of FA2's pre-acquisition surplus. However, FA2 will have sufficient exempt earnings for the taxation year ending December 31, 20X6 such that the portion of the whole dividend deemed to be paid out of FA2's pre-

acquisition surplus would instead be deemed to be a separate whole dividend paid out of the exempt surplus as a result of the application of Reg. 5901(2)(a).

xi. On September 1, 20X6, FA2 is sold by FA1 to FA3 for fair-market value cash consideration that exceeds FA1's adjusted cost base of the FA2 shares (before any adjustment for pre-acquisition dividends) in the course of an internal reorganisation.

xii. FA2 remains, at all relevant times, a foreign affiliate of Canco1.

b) Scenario B



The facts are the same as those in Scenario A, except that:

i. FA1 and FA2 are both "foreign affiliates" of Canco2.

ii. FA3 is a wholly owned foreign subsidiary of Canco1 and resident in a DTC.

iii. On June 1, 20X6 (more than 90 days after the start of its taxation year), FA2 pays a whole dividend to FA1. FA2 does not have sufficient surplus at the particular time for the whole dividend to be considered paid out of surplus such that, absent access to the 90-day rule in Reg. 5901(2)(a), a portion of the whole dividend would be deemed to be paid out of FA2's pre-acquisition surplus. However, FA2 will have sufficient exempt earnings for the taxation year ending December 31, 20X6, so that the portion of the whole dividend deemed to be paid out of FA2's pre-acquisition surplus would instead be deemed to be a separate whole dividend paid out of the exempt surplus to the extent Reg. 5901(2)(a) were to apply.

iv. On September 1, 20X6, FA2 is sold by FA1 to FA3 for fair-market value cash consideration that exceeds FA1's adjusted costs base of the FA2 shares (before any adjustment for pre-acquisition dividends) in the course of an internal reorganisation.

v. FA2 ceases to be a foreign affiliate of Canco2.

c) Question

In Scenario A, all of the requirements in Reg. 5901(2)(a) are met so that the portion of the whole dividend deemed to be paid out of FA2's pre-acquisition surplus on June 1, 20X6 should be subject to the 90-day rule. FA2 will be deemed to have paid a separate whole dividend out of its exempt surplus immediately after the end of its taxation year ending December 31, 20X6. In addition, FA1 will include in its exempt surplus, on June 1, 20X6, the separate whole dividend received from FA2.

However, it is not clear how the 90-day rule in Reg. 5901(2)(a) applies in Scenario B. Based on one possible interpretation, not all of the requirements in Reg. 5901(2)(a) appear to be met, as FA2 is not a foreign affiliate of Canco2 at all relevant times. This seems anomalous in a situation where, at all relevant times, FA2 is a member of the Canco1 group, as it would potentially give rise to hybrid surplus in FA1 on the sale of the FA2 shares and exempt surplus in FA2 without the corresponding funds to be able to distribute such surplus to FA3.

Would the Department consider a legislative amendment, perhaps by amending paragraph 95(2)(n), in order to clarify the application of Reg. 5901(2)(a) in situations such as Scenario B?

DRAFT RESPONSE: The Department agrees that, under one possible interpretation of paragraph 5901(2)(a) (the so-called "90-day rule"), not all of the requirements of that provision are met in Scenario B. If the 90-day rule is interpreted in this manner,

- the dividend paid by FA2 to FA1 in Scenario B would be considered to be paid out of FA2's pre-acquisition surplus, and not its exempt surplus, and

- it would seem that FA2 would have exempt surplus in respect of Canco1, without the corresponding funds to be able to distribute that surplus to FA3 (since FA2 would have already distributed those funds to FA1 by way of the dividend).

The Department agrees that it may be appropriate that the 90-day rule apply in Scenario B, in view of the fact that the Canadian parent retains the same indirect interest in FA2 at all relevant times. Before definitively concluding that the 90-day rule should apply in these circumstances – and, if so, whether this warrants a legislative amendment – the Department would like to discuss this issue with the CRA to understand how they have generally interpreted and applied the 90-day rule in these circumstances. Depending on those discussions, legislative amendments may be appropriate to ensure the intended results. The Department will reach out to the CRA, and TEI has offered to participate in any follow-up discussions.

In addition, if it were determined that a legislative amendment would be appropriate to ensure that the 90-day rule applies in the circumstances of Scenario B, it would be necessary that the rule also be amended to ensure the appropriate adjustments are made to foreign

affiliate surplus balances to reflect that the dividend is deemed to be paid out of exempt surplus. In particular, the rule would in that case need to be modified to clarify that, in Scenario B, the dividend payment by FA2 reduces FA2's exempt surplus balance in respect of not only Canco2 but also Canco1. This would prevent a situation where the application of the 90-day rule results in the dividend being considered to be paid out of FA2's exempt surplus, but, on one interpretation of that rule (which interpretation is contrary to the clear policy intent), FA2's exempt surplus balance in respect of Canco1 is not reduced accordingly.

2. *T4 Reporting and Regulation 102*

Consistent with TEI representations made to the Department prior to Budget 2015, and prior to the related amendment of subsection 200(1.1) of the Regulations, we propose that the Reg. 102 Certification regime be revisited to align the relief from withholding tax with the exemption from T4 reporting under the 45/90 day test. Specifically, would the Department revise subsection 200(1.1) of the Regulations as follows?:

(1.1) Subsection (1) does not apply in respect of

(a) an annuity payment in respect of an interest in an annuity contract to which subsection 201(5) applies; or

(b) an amount paid by a qualifying non-resident employer to a qualifying non-resident employee that is exempted under subparagraph 153(1)(a)(ii) of the Act ~~if the employer, after reasonable inquiry, has no reason to believe that the employee's total amount of taxable income earned in Canada under Part I of the Act during the calendar year that includes the time of this payment (including an amount described in paragraph 110(1)(f) of the Act) is more than $10,000~~.

We note that this amendment would be revenue neutral to the amount of withholding tax collected, and would significantly reduce the administrative costs to both taxpayers and the CRA. TEI believes that this will also encourage additional participants in the Reg. 102 Certification regime. If the Department is unwilling to make this proposed revision, would it please explain the rational for the existence of the $10,000 T4 reporting threshold currently contained in paragraph 200(1.1)(b) of the Regulations?

DRAFT RESPONSE: The current requirements were developed after extensive consultation with various stakeholders, which included the CRA. The $10,000/T4 requirements were included because they were seen as reasonable balances of efficiency sought by certain stakeholders while also providing information that the CRA needs for its compliance purposes. The Department noted that in the future, as the self-certification system matures, it may be willing to revisit this requirement.

In a follow-up to the above response, a TEI member noted that in a very recent discussion with the CRA, its position on the need for this information for compliance purposes may in fact have changed and may now be supportive of removing this requirement. The Department indicated that it would follow-up with CRA on obtaining a more current view on this matter.