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

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September 10, 2018

Brian Ernewein
General Director, Legislation
Tax Policy Branch
Department of Finance
90 Elgin Street,
Ottawa, ON K1A 0G5

Dear Mr. Ernewein:

Re: Legislative Proposals Released July 27, 2018

This submission sets out comments of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada ("**Joint Committee**") on the personal and business income tax proposals (the "**Proposals**") released July 27, 2018 to implement certain amendments to the *Income Tax Act* (Canada) (the "**Act**") from the Federal Budget tabled February 27, 2018 ("**Budget 2018**").

In respect of certain measures related to international tax, as you know, members of the Joint Committee are engaged in ongoing discussions concerning these measures with Finance officials. We look forward to continuing those discussions. In view of our ongoing dialogue, our comments on these measures are not included in this submission.

The Joint Committee gratefully acknowledges the willingness of Finance to engage in open discussions concerning these measures, and it is our hope that our dialogue will continue.

A number of members of the Joint Committee and others in the tax community participated in the discussions concerning this submission and contributed to its preparation, including:

- Ian Caines – Blake, Cassels & Graydon LLP
- Ian Crosbie – Davies Ward Phillips & Vineberg
- Ken Griffin – PwC LLP
- Josh Jones – Blake, Cassels & Graydon LLP
- Angelo Nikolakakis – EY Law LLP

- Kim G C Moody – Moodys Gartner Tax Law LLP
- Anthony V. Strawson – Felesky Flynn LLP
- Jeffrey Trossman – Blake, Cassels & Graydon LLP
- Bruce Ball – CPA Canada

We trust that you will find our comments helpful, and would be pleased to discuss them further at your convenience.

Yours very truly,

Ken Griffin	Jeffrey Trossman
Chair, Taxation Committee	Chair, Taxation Section
Chartered Professional Accountants of Canada	Canadian Bar Association

cc.: Ted Cook, Director General, Tax Legislation, Tax Policy Branch, Finance Canada

SUBMISSIONS

I. PERSONAL INCOME TAX MEASURES

1. Reporting Requirements for Trusts (Clauses 7-9)

Introduction

Under current law, a trust resident in Canada is generally exempt from the statutory obligation to file an annual income tax return unless tax is payable by the trust for the year, or the trust disposes of capital property in the year. Furthermore, even where a trust is required to file a tax return, there is currently no obligation to identify all of the trust's beneficiaries.

In Budget 2018, the Government stated its intention to amend the Act to impose a new filing obligation on certain trusts. In addition, Budget 2018 stated that trusts subject to the new filing obligation would be required to report the identity of all trustees, beneficiaries and settlors of the trust, and of each person (such as a "protector") who has the ability to exert control over trustee decisions. A list of specific exceptions was included in Budget 2018, including an exception for "lawyers' general trust accounts".

The Proposals give effect to these measures by proposing the enactment of new subsection 150(1.2), which provides that the filing exceptions in subsection 150(1.1) (for example, for a trust that has no tax liability), will not apply to a trust resident in Canada that is an "express trust" unless the trust is described in any one of paragraphs 150(1.2)(a) to (n). In addition, proposed section 204.2 of the Regulations will generally require disclosure by trusts required to file income tax returns of all trustees, settlors, beneficiaries and protectors (and similar persons). Finally, the Proposals (new subsections 163(5) and (6)) include dramatically enhanced "gross negligence" penalties (no less than 5% of fair market value of trust assets) for persons who fail to file returns or make or participate in the making of false statements or omissions.

The proposed amendments apply to taxation years ending after December 30, 2021 (meaning the 2021 taxation year in most cases).

Exceptions are too narrow

The Joint Committee understands and fully acknowledges the legitimate interest of CRA in obtaining sufficient information to assess taxpayers' liabilities. It may well be that CRA's capacity to enforce the provisions of the Act will be enhanced by these measures. Nonetheless, we believe that, in some respects, the Proposals are disproportionate. We believe that, due to the narrowness of the exceptions in paragraphs 150(1.2)(a) to (n), onerous compliance obligations will be imposed in some situations that are realistically very unlikely to produce meaningful information for CRA.

Quantitative Limit

Paragraph 150(1.2)(b) exempts trusts holding assets whose total fair market value does not exceed $50,000 throughout the year, if, but only if, those assets are restricted to cash, government debt obligations, shares, debts, or rights that are listed on a designated stock exchange, mutual fund shares or units, and interests in segregated funds. This exception appears to be a *de minimis* rule designed to relieve trustees of "small" trusts that do not owe tax of the new filing obligations.

We question the appropriateness of an arbitrary $50,000 limit, especially when that limit applies throughout the year. It is not difficult to imagine a situation where a trust's investment assets temporarily rise above $50,000 due to unforeseen market fluctuations. This highlights the fact that with a fair market value test, the value of investments would have to be checked continuously. We suggest that a more predictable and easily monitored limit would be appropriate. **We recommend that the quantitative limit specified in paragraph 150(1.2)(b) should be based on cost amount, rather than fair market value**

of the trust's assets. Such a change would provide added predictability, as cost amount is much less likely than fair market value to fluctuate from time to time. We acknowledge that in some circumstances, for example where the permitted investments of an entity include derivative contracts, a limit based on "cost amount" could potentially be manipulated. However, in the present case, given the narrowness of the permitted investments referred to in paragraph 150(1.2)(b), we do not believe this should be a genuine concern.

Short-term Trusts

Paragraph 150(1.2)(a) exempts trusts that exist for less than three months. We understand this exception reflects a determination that the time and expense of filing a return would be inappropriate for trusts that exist only for a very short period of time. We believe such an exception is sensible, but we question whether three months is appropriate.

It is frequently the case that proceeds of sale of a business are deposited in escrow to secure potential claims under contractual indemnities. However, a three month period is shorter than we are accustomed to seeing in many commercial transactions. We have not surveyed other common commercial transactions where funds are held in trust, but we assume that similar concerns could arise. **We therefore recommend that the duration of existence of a trust referred to in paragraph 150(1.2)(a) be increased to at least six months. We also recommend the Department consider an independent non-time-limited exception for trusts the principal purpose of which is to secure a potential contractual claim in the context of an arm's length transaction for the purchase or sale of a business (whether structured as a share sale or an asset sale).** It seems to us that the scope for abuse in this context is limited or non-existent.

Trusts holding Family Owned Personal Use Property

We also question whether there should be an exception for other non-tax paying trusts in circumstances where there is realistically a low likelihood that the additional information to be obtained by CRA from requiring such trusts to file would be of any use in administering the Act. One example is a situation where a family-owned personal-use property, such as a cottage, is held in a trust for the benefit of members of an extended family. Such trusts are typically established for non-tax reasons in a family context. A trust is often a convenient ownership vehicle to facilitate sharing and governance of a family-owned personal use asset, and inter-generational transfers.

Such assets will in most cases have a fair market value (or cost if our earlier recommendation is adopted) in excess of $50,000. It seems disproportionate to subject such trusts to the compliance burden associated with the filing of an income tax return in such circumstances. Furthermore, the "non-commercial" nature of many such arrangements increases the likelihood that the individuals involved will be unaware of the new tax compliance obligations of the trust, and thus exposed to penalties. **We therefore recommend that a separate exception be included in subsection 150(1.2) for a trust the principal purpose of which is to hold personal-use property in a family context.** We would be pleased to work with Finance on the development of suitable criteria for such an exception.

Short-lived Estates

When an individual passes away, his/her property is typically held by a testamentary trust until administration is complete. For smaller estates, the property in question may include personal use property and if no income or gains arise as part of the administration process, we understand that trust returns are often not filed. Although a reporting exemption has been proposed in paragraph 150(1.2)(i) for graduated rate estates (GREs), we believe there is circularity with this exception as currently drafted. For an estate to be a GRE, a return must be filed, and the estate must be designated as a GRE in that return. In this context as well, we believe the consideration should be given to extending the three-month exception, as more time will frequently be required to administer even a small estate. We therefore recommend that an exception be available for smaller estates that does not require the estate to be a GRE. We believe it would be reasonable for such an exception to apply where (i) the estate would have

been a GRE had a return been filed in which the required designation is made, (ii) the estate is wound up within a reasonable amount of time (to be determined), and (iii) the deceased's will is filed with the CRA as part of the deceased's terminal tax return. We would be pleased to discuss this further.

Lawyers' Trust Accounts

Paragraph 150(1.2)(c) exempts from the filing requirement a trust that "is required under the relevant rules of professional conduct or the laws of Canada or a province to hold funds for the purposes of the activity that is regulated under those rules or laws, provided that the trust is not maintained as a separate trust for a particular client or clients".

This appears to give effect to the proposal in Budget 2018 to exempt "lawyers' general trust accounts", and indeed may go beyond lawyers' trust accounts and may also cover similar arrangements involving other professionals such as for example notaries and real estate brokers.

We are extremely concerned about the proviso which effectively requires the filing of trust returns for lawyers' and notaries' trust accounts maintained for particular clients. On its face, this new requirement appears to require a lawyer or notary who holds monies in a dedicated trust account for a particular client (other than in connection with an arrangement that exists for less than three months[1] or under a "bare trust" arrangement[2]) to file a tax return disclosing, among other things, the name of the client, and the amount held in trust. Such a required disclosure is clearly contrary to the fundamental principle of solicitor-client privilege.

This requirement is inappropriate, and should not be enacted in its current form. The proposed rule undermines, and fails to respect, solicitor-client privilege. This raises fundamental legal and constitutional issues.

The Supreme Court of Canada recently considered the impact of onerous tax disclosure obligations as they apply to lawyers and notaries in respect of their clients in the *Chambre des notaires du Québec* case[3]. In that case, the Court "read down" subsection 232(1) and section 231.7, and declared that they are inapplicable to lawyers and notaries in their capacities as legal advisors. The Court also struck down the so-called "accounting records" exception contained in those provisions, holding that this exception cannot be justified constitutionally in light of the fact that the exception undermined solicitor-client privilege. The Court held that "where the interest at stake is the professional secrecy of legal advisers, which is a principle of fundamental justice and a legal principle of supreme importance, the usual balancing exercise under section 8 [of the Charter of Rights] will not be particularly helpful" [emphasis added]. Instead, privilege must be very clearly protected.

In the course of its reasons in *Chambre des notaires,* the Court stated (at para. 74):

> "It is important to note that clients' names may appear in accounting records that contain information about amounts received by and owed to a notary or lawyer. In some cases, those names may be privileged, since the fact that a person has consulted a notary or lawyer may reveal other confidential information about the person's personal life or legal problems".

The Proposals would in some circumstances obligate a lawyer or notary to file a tax return for a trust account established for a particular client, and to thereby disclose, among other things, the name of the client and the amount received from that client. This information would violate the reasonable expectations of clients to privacy in connection with their dealings with lawyers. Based on the principles in *Chambre des notaires*, it follows that any legislation that could abrogate privilege in this manner would

[1] Proposed paragraph 150(1.2)(a).

[2] Subsection 104(1). While, in many cases, funds held in trust by a lawyer or notary may be held in a "bare trust" arrangement, which is generally deemed not to be a trust for income tax purposes, this will not always be the case.

[3] 2016 DTC 5067. That case concerned the "Requirements" regime in sections 232 and 231.7.

be subject to being struck down by a Court in the same way the so-called “accounting records” exception in subsection 232(1) and section 231.7 was declared by the Supreme Court of Canada to be unconstitutional, and of no force or effect.

We would also note that the prospect of lawyers’ trust accounts being used in a manner that frustrates CRA’s ability to administer the Act is extremely remote. Rules of professional conduct for lawyers, and provincial legislation governing the practice of law,[4] strictly regulate the use of lawyers’ trust accounts. For example, the Law Society of Ontario’s *Rules of Professional Conduct* state that “a lawyer shall not use their trust account for purposes not related to the provision of legal services”.[5] The Commentary to this rule states:

> “A client or another person may attempt to use a lawyer’s trust account for improper purposes, such as hiding funds, money laundering or tax sheltering. These situations highlight the fact that when handling trust funds, it is important for a lawyer to be aware of their obligations under these rules and the Law Society’s by-laws that regulate the handling of trust funds”.[6]

A lawyer’s trust account may only be used in connection with the lawyer’s legal services. It would be a breach of the *Rules* for a lawyer to use his/her trust account in any other way or for any other purpose. A lawyer that permits his/her trust account to be used in connection with breaches of tax legislation could be penalized by the Law Society, even potentially disbarred. It is reasonable to expect lawyers to abide by their governing rules of professional conduct, and not to allow their trust accounts to be used to assist clients in escaping their tax obligations. Realistically, an exception for all lawyers’ and notaries’ trust accounts would not materially impair CRA’s ability to enforce the Act, and such an exception is appropriate in view of the constitutional importance of the protection of solicitor-client privilege as a “legal principle of supreme importance”.

We therefore recommend that proposed paragraph 150(1.2)(c) be amended to specifically exempt from the filing obligation any trust maintained by a lawyer or notary in accordance with the rules of professional conduct governing such person.

Proposed penalty is disproportionate

The “gross negligence” penalty proposed by new subsection 163(6) is the greater of $2,500 and “5% of the highest amount at any time in the year that is equal to the total fair market value of all property held by the trust”.

While it is acknowledged that this penalty would apply only in situations involving knowledge or gross negligence, the amount of the penalty is in our view potentially confiscatory, and therefore inappropriate. One can easily imagine situations in which the size of the penalty bears no realistic relationship to the extent of the trust’s failure. Furthermore, we are not aware of comparable situations in which the penalty for failure to file is computed as a percentage of the fair market value of the property of the person in question.

Consider for example a situation involving a family trust that holds a personal use property such as a cottage. Failure to file a tax return may in some circumstances be considered wilful (or grossly negligent) and could result in a penalty the quantum of which is punitive, especially given the fact that the trust’s assets are illiquid. In such a situation, the family might be forced to sell or encumber the property just to pay a penalty for failure to file an income tax return for a non-commercial trust that has no income. This seems inappropriate to us.

Another situation involves a foreign trust that might potentially be deemed resident in Canada under section 94 of the Act. The rules in section 94 are extremely complex, requiring taxpayers to navigate a

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[4] In Ontario, for example, By-law 9 of the Law Society of Ontario provides detailed rules on lawyers’ trust accounts.

[5] Section 3.2-7.3

[6] Commentary to Rule 3.2-7.

multiplicity of interrelated definitions and concepts in order to determine whether a particular foreign trust is deemed to be resident in Canada for purposes of the Act. Inevitably, situations will arise where there is a disagreement between CRA and a taxpayer regarding the status of a foreign trust as a deemed resident of Canada under section 94. The prospect of a crippling penalty for an allegedly wilful (or grossly negligent) failure to file a Canadian tax return for such a trust – even one that has zero Canadian income tax liability -- seems disproportionate and inappropriate.

We suggest that consideration should be given to other penalties that apply under the *Income Tax Act* (Canada) ("Act"). For example, would the graduated penalties that currently apply under subsections 162(10) and (10.1) for foreign reporting purposes be more appropriate for the proposed trust reporting requirements to maintain fairness and consistency?

We therefore recommend that the penalty provisions of proposed subsection 163(6) be reconsidered. In any event, we recommend that a trust that is resident in Canada solely because of being deemed to be resident in Canada under section 94, and which would not have been obligated to file a Canadian tax return in the absence of subsection 150(1.2) should not be subject to the penalty referred to in subsection 150(5).

II. BUSINESS INCOME TAX MEASURES

1. At-risk Rules for Tiered Partnerships (Clause 15)

Limited partnerships are a prevalent and important business structure in Canada. There are many reasons for this, including the absence of a flow-through regime for corporate structures (unlike the United States) and the absence of consolidated reporting (also unlike the United States). We believe that the current provisions of the Act create various undesirable burdens on taxpayers using such structures, and that the proposed amendments described below will exacerbate those burdens. We submit that the functioning of the Act could be improved to reduce such burdens on taxpayers and at no revenue cost to governments.

In our letter to you dated January 19, 2018 we anticipated that, in response to the decision in *Green v. R.*, 2017 FCA 107, the Department of Finance might consider amending the Act to provide that all portions of section 96 apply to partnerships where such partnerships are members of other partnerships (i.e., tiered partnerships). We noted at that time that, although such an approach would have some appeal, it could give rise to unintended consequences. We recommended that, whichever approach is adopted by the Department, taxpayers should have the ability to carryover unused limited partnership losses to future years in which the upper-tier partnership has an amount at risk in respect of the lower-tier partnership.

We note that the July 27, 2018 draft legislation effectively proposes to apply all portions of section 96 to tiered partnerships, without any ability to carryover unused limited partnership losses. We understand that the Department opted to exclude such a carryover due to a concern over potential complexity.

We are writing to suggest two alternative methods by which the proposals could be revised to address the Department's concerns and yield what we submit would be a more appropriate result. Although both alternatives necessarily would entail some additional complexity, we believe that the additional complexity is modest and warranted in the circumstances. We also note that addressing some of the other problems observed in our January 19, 2018 letter would result in reduced complexity and a better functioning tax system. We recognize that the discussion that follows does not explore in detail the statutory changes that would be required to effect either proposal, and that the Department will be concerned that the detailed provisions do not lead to inappropriate collateral effects. The purpose of this discussion is to outline two possible approaches that we believe would be viable to address the concerns we raise in this letter. We would be pleased to engage with you to assist in developing detailed legislative approaches to these matters (including through preparation of initial proposed amendments for consideration and other relevant methods by which the Act could be simplified) while addressing any concerns that the Department may have.

First Alternative - Ability to Elect Out of Default Approach in Defined Circumstances

Under the July 27, 2018 draft legislation, a loss of a lower-tier partnership that exceeds an upper-tier partnership's amount at-risk in that lower-tier partnership is denied forever. Consequently, tiered partnerships are not treated consistently with non-tiered partnership structures under the proposals. As noted above, in our view the appropriate policy result would be to not deny these losses permanently but would be to allow their deduction where the appropriate amount is at risk. We understand that the proposed complete denial results from concerns over complexity.

An alternative approach would be for the treatment in the July 27, 2018 draft legislation to be the default, with an ability to elect out of the default in certain defined circumstances when a subsequent "release event" occurs.[7] A release event would be anything that increases the amount at-risk in the lower tier

[7] The alternative could also be automatic rather than elective, but for simplicity we will refer to it herein as elective.

partnership, such as an investment in the lower-tier partnership or the earning of income in the lower-tier partnership. When the release event occurs and the election is made by the ultimate partners, the previously denied loss would be allocated to the ultimate partners to the extent of the amount now at-risk in the lower-tier partnership, and the ACB of the ultimate partners in the upper-tier partnership would be reduced accordingly.[8]

To minimize additional complexity, we recommend under this alternative that the ability to elect out of the default approach be limited to certain defined circumstances where information will be known by the ultimate partners and potential abuse will not be a concern. The most obvious example would be where there has been no change in the ultimate partners or their relative partnership interests between the time the loss arose and the time when the release event occurs.[9]

If this alternative is of interest, we would be pleased to engage with you on identifying the other appropriate examples for relief.[10]

Second Alternative - Track Limited Partnership Losses to Indirect Partners

Our second alternative would be non-elective, and would involve two targeted changes to the current limited partnership loss regime in order to allow ultimate partners to carryforward and use limited partnership losses from lower-tier partnerships in certain cases, while minimizing concerns regarding loss trading and other abuse. Depending upon how it is implemented, this alternative could be simpler than the first alternative, but at the expense of potentially yielding more outcomes that may not be "perfect", from a policy perspective.

These two changes would be:

- *Creation of limited partnership losses in tiered structures.* The definition of limited partnership loss in subsection 96(2.1) would be amended to provide that where an upper-tier partnership has a limited partnership loss in respect of a lower-tier partnership, such limited partnership loss (in respect of the particular lower-tier partnership) will be allocated to the partners of the upper-tier partnership. As a result, when limited partnership losses arise in a tiered partnership structure, such limited partnership losses would be allocated out to the ultimate partners but retain their character as being associated with the lower-tier partnership that originally gave rise to the loss.
- *Utilization of limited partnership losses in tiered structures.* Paragraph 111(1)(e) would be amended to allow for the deduction of limited partnership losses only when there is sufficient at-risk amount in the lower-tier partnership that originally gave rise to the loss ***and*** in each other partnership (if any) in the structure between that lower-tier partnership and the ultimate partner.

In order to further simplify the administration of this proposal, instead of adjusting ACBs throughout the structure when the limited partnership losses are claimed the rules could instead provide, in certain circumstances where ACB calculations are difficult, for the ultimate partner to also realize a capital gain when it deducts limited partnership losses in respect of a lower-tier partnership in which it is an indirect partner.

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[8] To the extent ACB becomes negative, a deemed gain would arise pursuant to existing rules. An alternative would be to treat the "released loss" as a loss of the upper-tier partnership for the year, such that the existing at-risk rules (together with our alternative proposal, on an iterative basis as required) could apply for partners of the upper-tier partnership that have insufficient at-risk amounts at that time.

[9] The Department might also wish to impose a requirement that there be no intervening loss restriction event of any partner, although we note that such a requirement would go further than the current at-risk rules for non-tiered partnership structures.

[10] To minimize complexity, the most obvious appropriate examples could be provided for in the legislation, along with any other circumstances as may be prescribed in the future or where considered just and equitable by the CRA. In that way, the Act would not need to anticipate every possible scenario warranting relief, but nevertheless be flexible enough to allow for relief where appropriate.

Because this proposal would link limited partnership losses to both the underlying partnership that gave rise to the loss, and to the ultimate (non-partnership) partner, concerns about the trading of limited partnership losses should be minimized. If abuse remains a concern, rules could be provided to restrict the ability to deduct such a limited partnership loss if there are significant changes in the amount or form of the ultimate partner's indirect interest in the lower-tier partnership after the loss arises.

Our letter of January 19, 2018 identified certain other aspects of the rules applicable to limited partnerships that, in our view, are not reflective of the general policy framework of the taxation of partnerships. We would hope to engage further with the Department with respect to these matters in the course of developing proposals to deal with the limited partnership loss issue.

III. INTERNATIONAL TAX MEASURES

1. Cross-Border Surplus Stripping using Partnerships and Trusts - 212.1 (Clause 16)

Section 212.1 is a longstanding cross-border “surplus stripping” rule.

The conditions for application of the rule are specified in subsection 212.1(1), and are essentially as follows:

(a) A non-resident person (“**NR Seller**”) disposes of “subject shares” – being shares of a corporation resident in Canada (“**Canco**”);

(b) The disposition is made by NR Seller to another corporation resident in Canada (“**Can-Buyer**”);

(c) NR Seller and Can-Buyer do not deal at arm’s length (otherwise than because of a paragraph 251(5)(b) right); and

(d) Can-Buyer is “connected” with Canco (within the meaning of subsection 186(4)) immediately after the disposition.

The consequences of the rule applying are specified in subsection 212.1(1.1), and are essentially as follows:

(a) Any non-share consideration, or “boot”, provided by Can-Buyer to NR Seller is deemed to be a dividend paid by Can-Buyer to NR Seller, to the extent it exceeds the paid-up capital, or “**PUC**”, of the subject shares, and

(b) The PUC of any shares issued by Can-Buyer to NR Seller is reduced from the amount otherwise determined down to the amount of the PUC of the subject shares (net of any boot).

It was noted in Budget 2018 that the existing rule does not apply to a transfer by NR Seller to Can-Buyer of interests in partnerships or trusts that themselves own subject shares. The existing rule therefore leaves open the possibility that the above-noted consequences – deemed dividend or PUC grind – would not apply where the subject matter of the transfer is an interest in a partnership or trust through which NR Seller owns shares of Canco. Budget 2018 stated that “look-through” rules would be added to section 212.1 in order to effectively treat members of partnerships (or beneficiaries of trusts) as owning the underlying Canco shares owned by such vehicles.

The Joint Committee understands that, as a policy matter, the legislation should not permit the basic rule to be avoided through the inter-position of a fiscally transparent entity. However, we believe the Proposals overshoot the stated objectives.

The source of the excessive breadth is contained in the new operative rule in proposed subsection 212.1(6).

Paragraph 212.1(6)(a) provides essentially that where shares of a Canco are owned by an intermediate trust or partnership (each referred to as a “**conduit**”), each member (or beneficiary) of the conduit is treated as owning its *pro rata* share of the underlying Canco shares, based on the fair market value of such member’s (or beneficiary’s) interest.

Paragraph 212.1(6)(b) sets out a special interpretive rule that applies for purposes of subsection 212.1(6). This rule states that if:

(i) a holder disposes of an interest in a conduit (a "**pertinent interest**") to a purchaser, and

(ii) "any portion of the fair market value of the pertinent interest is attributable to shares of the capital stock of a corporation resident in Canada held, directly or indirectly by the conduit" ("**Canco shares**"),

then

(iii) the holder is deemed to have disposed of its *pro rata* share of the shares held by the conduit, and

(iv) the holder is deemed to have received from the purchaser, as consideration for the shares deemed to have been disposed of, non-share consideration (i.e., boot) in an amount corresponding to the fair market value of the holder's indirect interest in the underlying shares.

The portion of paragraph 212.1(6)(b) that "looks through" any intermediate entity between the conduit and the Canco shares is overly broad because it looks through non-transparent entities, including foreign taxable corporations. Consider for example the following situation:

(a) NR Seller ("**NRco**") owns an interest in a partnership;

(b) The partnership owns shares of a US corporation ("**USco**"); and

(c) USco owns shares of a Canadian subsidiary ("**Canco**") which account for a relatively small portion, say, 20%, of the fair market value of the USco shares.

If NRco sells its partnership interest to a non-arm's length Can-Buyer, it appears that this will be deemed to be a sale of the underlying Canco shares, potentially engaging the operative rules of section 212.1. Yet, if NRco had instead directly owned the USco shares, and sold those shares to a non-arm's length Can-Buyer, there would have been no disposition of an interest in a "conduit", and therefore section 212.1 would not have applied.[11] It seems to us that the policy considerations in the two situations are the same.

We would suggest that this example illustrates the way in which the proposed wording of paragraph 212.1(6)(b) is overly broad. There may be other anomalies that flow from the very broad "directly or indirectly" language used in paragraph 212.1(6)(b).

We therefore recommend that the rule only "look through" fiscally transparent entities such as intermediate partnerships or trusts (i.e., other "conduits"), but not intermediate corporations such as USco.

At the very least, there should be some sort of *de minimis* rule under which intermediate non-resident corporations such as USco are not "looked through" where the portion of the fair market value of the pertinent interest falls below a specified threshold, such that the indirect disposition of the Canco shares

[11] It is acknowledged that, depending upon the circumstances, it is possible that the foreign affiliate dumping rules in section 212.3 could apply to such a transaction.

is incidental, rather than central, to the transaction.[12] We would be pleased to discuss potential ways of drafting a modified version of paragraph 212.1(6)(b) that does not inappropriately catch transfers of interests in trusts or partnerships that indirectly own interests in Canadian corporations through intermediate non-resident corporations.

2. Foreign Affiliates – Tracking Arrangements (Clauses 20, 21)

Budget 2018 described a tax avoidance strategy whereby certain groups of Canadian taxpayers have used "tracking arrangements" to avoid controlled foreign affiliate ("CFA") status. These arrangements were described as situations where each taxpayer "retains control over its contributed assets and any returns from those assets accrue to its benefit". It was noted that avoidance of CFA status may be effected through the use of "separate cells or segregated accounts" that track the contributed assets. No draft legislation was included with the Budget.

The Proposals would give effect to this measure through proposed subsections 95(10) to 95(12). In contrast to the tax avoidance strategy described in the Budget, these provisions appear to be purely mechanical rules that will apply in a wide array of benign situations having nothing whatsoever to do with tax avoidance. We are concerned that these measures, if enacted as proposed, will give rise to inappropriate outcomes in a range of situations that are very different from those identified in Budget 2018.

In the short time available for consultation, we have identified two specific issues with the proposed measures, discussed below. We are concerned that these proposed mechanical rules, having no connection to tax avoidance, are apt to give rise to other anomalous outcomes that cannot be predicted now, and we would therefore urge Finance to consider changing the text of the provisions so they are clearly anti-avoidance rules, consistent with the narrative in Budget 2018.

Election required to achieve appropriate result

Many foreign investment funds are set up as "umbrella funds" that are legally structured as single corporations with several distinct sub-funds, each of which is a separate investment fund for commercial and regulatory purposes. The use of a single legal entity reduces regulatory costs compared to using separate legal entities for each sub-fund and is generally simpler to administer. Such arrangements are quite common.

Typically, each sub-fund has a number of separate classes or series designed for investors who want to invest in that sub-fund using a particular currency. For example, a particular sub-fund may have a Canadian dollar class or series, which is designed specifically for Canadian investors who seek a Canadian-dollar denominated return. In some cases, there will be very few Canadian investors in the particular sub-fund. In respect of the Canadian dollar class or series, the manager will typically hedge all or a portion of the sub-fund's non-Canadian dollar exposure back to the Canadian dollar.

If a Canadian investor holds 10 percent or more of the shares of a Canadian dollar class or series of a sub-fund, then the entire umbrella fund would be a foreign affiliate ("FA") of the Canadian investor. This will often be the case because, while there may be many investors in a sub-fund, there may not be many investors in the Canadian dollar class or series of the sub-fund. Because an umbrella fund would typically have more than one sub-fund, the Canadian investor's shares that track the results of the applicable sub-fund would be "tracking interests", as currently drafted. Accordingly, if the umbrella fund has any "foreign accrual property income" ("FAPI"), the umbrella fund would be a CFA of the Canadian taxpayer, and the Canadian taxpayer may be taxed currently on its participating percentage of that FAPI.

[12] More broadly, even in the absence of a non-transparent entity in the chain of ownership, we question whether this new anti-avoidance rule should apply where the Canco shares represent a very small portion (say less than 10%) of the fair market value of the transferred "conduit" interest.

We appreciate that in many circumstances a Canadian investor in an umbrella fund could make the election in proposed subsections 95(11) and 95(12) to avoid the potentially significant adverse impacts of the entire umbrella fund being a CFA of the Canadian investor; however, it is unlikely that typical investors (including in particular retail investors) will be aware of the need to make such an election, and, as currently drafted, the election can only be made on or before the filing due date for the particular taxation year. We question whether it is appropriate to require retail investors to make an election in order to avoid such an inappropriate result. We therefore recommend that the default rule be that proposed subsection 95(12) apply where the conditions in proposed subsection 95(11) are met and that a taxpayer be permitted to elect to have the rule in proposed subsection 95(10) apply.

Currency differences should not be sufficient to create a separate tracking interest

We are also concerned that, even if a Canadian investor makes the election for subsection 95(12) to apply in respect of an investment in a sub-fund, the sub-fund may still be a CFA of the Canadian investor if the sub-fund hedges its non-Canadian dollar exposure back to the Canadian dollar. This is because it appears that the applicable "tracked property and activities" for purposes of proposed paragraph 95(12)(a) will be only the property of the applicable sub-fund that is attributable to the Canadian dollar class or series because of the separate property of the sub-fund that is used for hedging purposes. In other words, the interests in the Canadian dollar class or series will be seen as a separate tracked interest from the other interests in the particular sub-fund.

In such a situation, the only holders of shares of the deemed corporation referred to in proposed paragraph 95(12)(a) would likely be Canadian resident investors. Because of the concept of "relevant Canadian shareholders" in the definition of a CFA, the deemed separate corporation may be a CFA of each Canadian investor for which the umbrella fund is an FA. This means that Canadian investors that hold only a relatively small number of shares of the sub-fund, but more than 10% of the shares of the Canadian dollar class or series of the sub-fund, may be caught by the new proposed rules even if they make the election for proposed subsection 95(12) to apply.

We submit that currency hedging arrangements do not fit within the scope of the mischief that is targeted by the proposed rules relating to tracking interests. We therefore recommend that the definition of a tracking interest in proposed subsection 95(8) should be revised to clarify that tracked property and activities not include a situation where property represents less than all of the property and activities of a foreign corporation solely because of differences in the currency denomination of a particular class or series of interests. The exclusion could be similar to the carve-outs in subparagraph (b)(iii) and clause (c)(i)(C) of the definition of a "derivative forward agreement".

3. Reporting Requirements for Foreign Affiliates – T1134 Deadline (Clause 24)

The Proposals continue to propose a six-month filing deadline for the T1134 information return. We continue to believe this deadline is unduly short, for the reasons described in our May 18, 2018 submission. As we noted in that submission, we are concerned that the information necessary for taxpayers to file accurate T1134 information returns will very frequently not be available within six months of the end of the taxation year. This could result in multiple filings as accurate information becomes available, increasing compliance burdens for taxpayers and administrative costs for the CRA. We would encourage Finance (and the CRA) to continue to consult with affected taxpayers to resolve these concerns, and we would be pleased to help facilitate these discussions.

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As noted above, our dialogue concerning certain international measures is ongoing, and consequently our comments on these measures are not included in this submission.