Le Comité mixte sur la fiscalité de l'Association du Barreau canadien et de l'Institut Canadien des Comptables Agréés

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Le 14 novembre 2011

Monsieur Brian Ernewein
Directeur, Division de la législation de l'impôt
Direction de la politique de l'impôt
Ministère des Finances du Canada
L'Esplanade, tour Est, étage
140, rue O'Connor
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Objet : Projet de loi C-13 – Règles portant sur le report d'impôt des sociétés prévues aux articles 34.2, 34.3 et 249.1 de la *Loi de l'impôt sur le revenu* du Canada

Monsieur,

Vous trouverez ci-joint notre mémoire qui porte sur les dispositions du projet de loi C-13 proposant de limiter les reports d'impôt par une société détenant une participation notable dans une société de personnes dont l'exercice ne coïncide pas avec l'année d'imposition de la société.

Nous sommes heureux que ces dispositions tiennent compte de certaines préoccupations créées par les nouvelles règles que nous avions déjà mentionnées au cours de notre réunion du 20 juin 2011. Notre mémoire porte sur certaines difficultés techniques qui persistent. Nous pensons que ces difficultés entraîneront des effets contradictoires aux objectifs énoncés en matière de politiques qui sous-tendent les nouvelles règles.

Plusieurs membres du Comité mixte, ainsi que des membres de leurs cabinets respectifs ont participé aux discussions et à l'élaboration de notre mémoire, notamment :

Steven Hurowitz, KPMG s.r.l., S.E.N.C.R.L.
Jeff Oldewening, KPMG s.r.l., S.E.N.C.R.L.
Alycia Cavert, Ernst & Young LLP

Ken Griffin, PricewaterhouseCoopers
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Mitchell Sherman, Goodmans LLP
Anthony Strawson, Felesky Flynn LLP
Jeffrey Trossman, Blake, Cassels & Graydon s.r.l., S.E.N.C.R.L.
Darcy Moch, Bennet Jones LLP
Bruce Ball, BDO s.r.l., S.E.N.C.R.L.

Les membres du Comité mixte se feront un plaisir de vous rencontrer afin de discuter plus amplement de notre mémoire à un moment qui vous conviendra.

Nous espérons que nos commentaires vous seront utiles.

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

D. Bruce Ball
Président, Comité sur la fiscalité
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L'Association du Barreau canadien

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SUBMISSION

1. Introduction

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (the "**Joint Committee**") is pleased to provide this submission on the provisions of Bill C-13 that introduce new sections 34.2 and 34.3 and amendments to section 249.1 of the *Income Tax Act* (Canada) (the "**Act**").[1]

2. Background

On June 6, 2011, the Minister of Finance (Canada) (the "**Minister**") delivered the 2011 federal budget (the "**Budget**").[2] One measure in the Budget proposed rules to limit a deferral opportunity for a corporation that owned a significant interest in a partnership where the fiscal period for the partnership differs from the taxation year of the corporate member. The measure would be patterned on existing sections 34.1 and 34.2 of the Act.

On August 16, 2011, the Department of Finance (Canada) ("**Finance**") released draft legislation to implement the new rules.[3] The draft legislation implemented the Budget measure as initially conceived with minor modifications.

On October 3, 2011, a Notice of Ways and Means Motion to enact the new rules was tabled in Parliament. It became Bill C-13, which underwent first reading in the House of Commons on October 4, 2011 and second reading on October 17, 2011.

3. Policy Objectives

Considered together, new sections 34.2 and 34.3 and amendments to section 249.1 reflect the following apparent policy objectives:

1 The ability to defer income earned by a corporation through a partnership should be limited.

2 Transitional relief should be provided to mitigate the cash flow impact of incremental corporate tax payable on the transition to the new rules.

4. Our Submission

In our submission, we identify certain issues under the new rules that lead to results inconsistent with their policy objectives. We suggest that these issues can be addressed without adding undue complexity.

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1 Bill C-13, *Keeping Canada's Economy and Jobs Growing Act*, 1st Sess., 41st Parl., 2011. In this submission, all statutory references are to the Act, as amended by Bill C-13.

2 Canada, Department of Finance, *The Budget Plan* (Ottawa: Queen's Printer, June 6, 2011).

3 *Legislative Proposals Relating to the Income Tax Act and Related Regulations*; and Canada, Press Release 2011-067, "Government of Canada Moving Forward with its Low-Tax Plan for Jobs and Growth," dated August 16, 2011.

5. Substantive Issues

5.1. Actual Stub Period Accrual and Adjusted Stub Period Accrual

5.1.1. Actual Stub Period Accrual

The parenthetical limitation in the description of variable B in the definition of "actual stub period accrual" in proposed subsection 34.3(1) is confusing. It combines a partnership-by-partnership concept with an aggregation concept. On one hand, the definition requires the actual stub period accrual to be calculated on a partnership-by-partnership basis. However, the parenthetical limitation appears to require that total allowable capital losses from all partnerships be compared to total taxable capital gains from all partnerships, without being clear as to how it is to be applied in respect of any particular partnership.

Consider the following example. A corporation has a significant interest in four qualifying partnerships, P1, P2, P3 and P4, with the following allocation of taxable capital gains (allowable capital losses) for a particular taxation year: ($200) from P1, $50 from P2, ($75) from P3 and $150 from P4. Total allowable capital losses exceed total taxable capital gains by $75. In computing the actual stub period accrual for P1, A will be $0 but what is B? Is it $0 because the total allowable capital losses exceed the total taxable capital gains? Is it $200? Or can it be $125, so that the $200 permitted allowable capital loss (that is the total of all allowable capital losses to the extent it does not exceed the total of all taxable capital gains) is comprised of P3's $75 allowable capital loss and $125 of P1's allowable capital loss?[4] Presumably, the intention of the rule is that there should be no net taxable capital gain, so that the overall $275 allowable capital losses can be allocated between partnerships P1 and P3 as the taxpayer chooses, but it is far from clear the language accomplishes that objective.

Recommendation –

The legislation should be revised to clarify that a taxpayer is permitted to deduct the total amount of allowable capital losses from all partnerships in such manner as the taxpayer chooses provided that the total of all allowable capital losses so deducted does not exceed the total taxable capital gains from all partnerships. If that is not acceptable, the Explanatory Notes should be clarified, perhaps with an example, to make the above principle clear.

5.1.2. Netting of Adjusted Stub Period Accrual for Multiple Partnerships

“Adjusted stub period accrual” is defined in subsection 34.2(1) by a formula. Under section 257, an amount determined by formula is deemed to be nil if the formula produces a negative

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[4] This result may be obtained if P3's actual stub period accrual is computed first. It would use ($75) for Variable B as that will not exceed the total of all taxable capital gains of P2 and P4: $200. This would leave taxable capital gains of $125 remaining permitting P1 to use ($125) for Variable B in its calculation of its actual stub period accrual. That is, in computing its actual stub period accrual P1 may deduct its allowable capital losses but only to the extent that the total of all allowable capital losses deducted by P1 and P3 does not exceed the total of all taxable capital gains: see the description “B” in the formula [(A – B) x C/D] – (E + F) in the definition “adjusted stub period accrual” in subsection 34.2(1).

amount, unless otherwise provided. Thus, a corporation cannot have negative adjusted stub period accrual in respect of a partnership. This means that a corporation that has a significant interest in more than one partnership cannot net adjusted stub period accrual in respect of the partnerships.

The issue can potentially be mitigated by way of a designation of an amount for F in the definition of adjusted stub period accrual in respect of the profitable partnership, to the extent of the expected loss in respect of the unprofitable partnership. By making such a designation, the corporation would avoid adjusted stub period accrual under subsection 34.2(2) to the extent of the designated amount but would be exposed to under-reported stub period accrual under subsection 34.3(3) if the designated amount in respect of the profitable partnership exceeds the loss actually realized by the unprofitable partnership.

In this sense, the rules place the onus on the corporation to designate an amount to avoid adjusted stub period accrual but do not relieve the risk of under-reported stub period accrual.

This result is difficult to reconcile with other aspects of the new rules in respect of which netting is automatic, such as variable “A” in the formula A + 0.5 x (A – B) in subsection 34.3(3), whereby each positive or negative amount of “income shortfall adjustment”[5] for each qualifying partnership of the corporation for the year is netted against each other.

Recommendation –

Allow a corporation that has a significant interest in more than one partnership to have a negative amount of adjusted stub period accrual in respect of a partnership that may be used to reduce an income inclusion under subsection 34.2(2) in respect of another partnership(s). The portion of such deduction that is attributable to allowable capital losses of the first partnership could be streamed against the portion of adjusted stub period accrual that is attributable to taxable capital gains of the other partnership(s).

5.1.3. Designation of Amounts in Computation of Adjusted Stub Period Accrual

In computing adjusted stub period accrual of a corporation in respect of a partnership, under the formulae in the definition of that term in subsection 34.2(1), a corporation may designate:

1 an amount of qualified resource expense under subsection 34.2(6) in its return of income for the year filed with the Minister on or before its filing-due date for the year; and

2 an amount designated by the corporation in its return of income for the year (other than an amount designated under subsection 34.2(6)) and filed with the Minister on or before its filing-due date for the year.

[5] Preamble to the definition “income shortfall adjustment” in subsection 34.3(1).

The filing-due date for the year in respect of a corporation is six months after the end of the year.[6] Once a designation has been made, subsection 34.2(10) prohibits an amendment or a revocation of the designation.

The deadline to make a designation is short. For a partnership that has a corporate partner with a March 30, 2011 taxation year-end, the time to make a designation for that year has expired. Other corporate partners whose filing-due dates for the 2011 taxation year precede the enactment of the new rules are required to make a designation on the basis of draft legislation that could change.

Recommendation –

Extend the deadline to make designations to the later of the period contemplated in Bill C-13 and a reasonable period such as 12 months after Royal Assent of Bill C-13.

5.2. Transitional Reserve for Qualifying Transitional Income ("QTI")

In a corporation's first taxation year ending after March 22, 2011, the corporation is required to include in income (i) its share of the income of a partnership in which it has a significant interest for fiscal periods ending in the taxation year under subsection 96(1), and (ii) its adjusted stub period accrual for the stub period of the partnership ending in the year under subsection 34.2(2). As a result, the corporation can be taxed on its share of income earned by the partnership over a period of more than twelve months. The reserve in subsection 34.2(11) mitigates the cash flow impact of such incremental corporate tax payable on the transition to the new rules.

In general, paragraph 34.2(11)(b) limits the reserve to the total of the amount of the reserve added back into income for the year under subsection 34.2(12) and, for the second year only, the increase to qualifying transitional income because of the application of subsections 34.2(16) and (17). We refer to this amount as the "**Prior Year Reserve Limit.**"

Paragraph 34.2(11)(c) limits the reserve generally to the amount of the income of the corporation before deduction of the reserve. We refer to this amount as the "**Income Limit**."

The reserve deduction can be restricted severely in a taxation year under paragraph 34.2(11)(c) if subsequent to March 22, 2011 a corporation either (i) does not have qualifying transitional income, or (ii) has low or nil income for a subsequent year.

A corporate member of a partnership should not be denied a reserve deduction on the basis of subsequent events after March 22, 2011 (other than the "true-up" of QTI under subsections 34.2(16) and (17)). To restrict the deduction of the reserve in these circumstances is inconsistent with the policy of relieving the cash flow impact of incremental tax payable arising on the transition to the new rules.

In this section, we explain how the reserve can be denied in cases that appear to be inconsistent with the policy objectives of the new rules.

[6] Definition "filing-due date" in subsection 248(1) and paragraph 150(1)(a).

5.2.1. Paragraph 34.2(11)(a) – Lack of Income due to No Fiscal Period of Partnership Ending in First Taxation Year of Corporation Ending After March 22, 2011

A reserve deduction under subsection 34.2(11) is not available to a corporate partner who has a significant interest in a partnership if the corporation has a taxation year that ends after March 22, 2011 but before the end of the partnership's first fiscal period ending in 2011, as the corporation has nil qualifying transitional income in respect of the partnership. Consider the following illustrative example:[7]

- C is a corporation that has a calendar taxation year.
- P is a partnership that has a fiscal period ending on June 30.
- C's only source of income is a significant interest in P.
- On May 1, 2011, there is an acquisition of control of C. C's taxation year is deemed to end at the last moment on April 30, 2011.[8]
- After the acquisition of control, C adopts a calendar fiscal period for commercial reasons.

P does not have a fiscal period ending in C's first taxation year ending after March 22, 2011 (namely, its taxation year ending on April 30, 2011). C has nil adjusted stub period accrual for such year.[9] Therefore, C has nil qualifying transitional income.[10] C is not entitled to deduct a reserve under subsection 34.2(11) in respect of the partnership in the year or any subsequent year in the transitional period.

This is so notwithstanding that C is required to include in income for its December 31, 2011 taxation year partnership income for an effective period of 18 months. This amount consists of its share of P's income for its 12-month fiscal period that ends on June 30, 2011 in such year, and adjusted stub period accrual under subsection 34.2(2) that represents a 6-month pro-ration of its share of P's income for its 12-month fiscal period that ends on June 30, 2011. As C has nil qualifying transitional income, the condition in paragraph 34.2(16)(a) is not met. Accordingly, subsection 34.2(17) does not apply to increase C's qualifying transitional income for its December 31, 2011 taxation year.

The result is inconsistent with the policy objective that transitional relief should be provided to mitigate the cash flow impact of incremental corporate tax payable on the transition to the new rules. A corporate member of a partnership should not be denied a reserve deduction on the basis

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7 A similar issue can arise if: (i) a corporation acquires a significant interest in a partnership before March 22, 2011 but the partnership does not have a fiscal period ending in its first taxation year ending after March 22, 2011; and (ii) a corporation forms a partnership in which it has a significant interest before March 22, 2011 but the partnership has a fiscal period ending after its first taxation year ending after March 22, 2011.

8 Subsections 256(9) and 249(4).

9 Paragraph (a) of the definition "adjusted stub period accrual" in subsection 34.2(1).

10 Subparagraph (b)(ii) of the definition "qualifying transitional income" in subsection 34.2(1).

of subsequent events that do not affect the computation of the income of the corporation for its first taxation year ending after March 22, 2011.

The issue did not arise under the 1995 amendments because an individual cannot have a deemed short taxation year and a professional corporation that carries on business in partnership typically does not have a deemed short taxation year by reason of an acquisition of control or an amalgamation.

Recommendation –

A corporate partner with a taxation year that ends in 2011 before the end of the partnership's fiscal period should be entitled to claim a reserve based on its adjusted stub period accrual for its first taxation year after March 22, 2011 that contains a fiscal period-end for the partnership.

5.2.2. Paragraphs 34.2(11)(b) and (c) – Nil Income in Taxation Year in the Transitional Period

A taxpayer's income for a year could be unusually low due to commercial factors such as an unexpected work stoppage.

Consider the following example whereby the Income Limit for a corporation is nil in a taxation year that falls in the transitional period:

- C is a corporation that has a calendar taxation year.
- P is a partnership that has a fiscal period ending on September 30.
- C's only source of income is a 50 percent partnership interest in P.
- C has deductible expenses (recurring interest expense) in each of its 2011, 2012 and 2013 taxation years of $5,500,000.
- P has income of $60,000,000, $60,000,000, $10,000,000 and $60,000,000 for its fiscal periods ended September 30, 2011, 2012, 2013 and 2014, respectively. The decrease in income of P for its 2013 fiscal period is due to an unexpected work stoppage in the fourth quarter of its fiscal period.
- P does not have qualified resource expenses.

The results for this example are tabulated below.

Year ended December 31	2011	2012	2013	2014	2015	2016
S. 96(1) income allocated from P for fiscal period ended September 30 (A)	30,000,000	30,000,000	5,000,000	30,000,000	30,000,000	30,000,000
S. 34.2(2) add: adjusted stub period accrual = (A) * 92/365 (note 1)	7,561,644	7,561,644	1,260,274	7,561,644	7,561,644	7,561,644
S. 34.2(4) deduct: prior year adjusted stub period accrual	-	(7,561,644)	(7,561,644)	(1,260,274)	(7,561,644)	(7,561,644)
Net partnership income accrual for the Stub Period	7,561,644	-	(6,301,370)	6,301,370	-	-
Income before transitional reserve (B)	37,561,644	30,000,000	(1,301,370)	36,301,370	30,000,000	30,000,000
S. 34.2(11) deduct reserve for year (note 2)	(7,561,644)	(6,427,397)	-	-	-	-
S. 34.2(12) add: prior year's reserve (C)	n/a	7,561,644	6,427,397	-	-	-
Other deductible expenses (D)	(5,500,000)	(5,500,000)	(5,500,000)	(5,500,000)	(5,500,000)	(5,500,000)
C's income for tax purposes	$24,500,000	$25,634,247	$ (373,973)	$30,801,370	$24,500,000	$24,500,000
Note 1						
For 2011, C's QTI includes its adjusted stub period accrual in respect of P which is based on P's income						
for the fiscal period ended September 30, 2011, *i.e.,* QTI = $30,000,000 x 92/365 = $7,561,644.						
No adjustment to QTI is made in 2012						
Note 2						
The deduction under s. 34.2(11) is equal to the lesser of:						
(a) Specified percentage x QTI	7,561,644	6,427,397	4,915,068	3,402,740	1,890,411	-
(b) Prior year reserve	n/a	7,561,644	6,427,397	-	-	-
+ positive "true-up"	n/a	n/a	n/a	n/a	n/a	n/a
	n/a	7,561,644	6,427,397	-	-	-
(c) Income Limit (B) + (C) + (D)	32,061,644	32,061,644	(373,973)	30,801,370	24,500,000	24,500,000
S. 34.2(11) reserve	7,561,644	6,427,397	-	-	-	-

Due to the work stoppage in 2013, C has an Income Limit of nil.[11] Therefore, C is denied a reserve for its 2013 taxation year.

While subparagraph 34.2(11)(b) is ambiguous,[12] it could be construed so as to deny C a reserve deduction in its 2014 and subsequent taxation years in the transition period on the basis that the Prior Year Reserve Limit for C's 2014 taxation year is nil because the Income Limit for its 2013 taxation year was nil. On this interpretation, the denial of the reserve in C's 2014 taxation year leads to a large notional increase in C's income for tax purposes in that year. The taxes payable on this large notional increase in income compound the cash flow impact to C of the decrease in income in 2013 and potentially lead to significant and adverse financial consequences for C. This result defeats the intended effect of the rules to bring in transitional income over a five year period. A different result would be obtained if paragraphs 34.2(11)(b) and (c) were simply deleted.

Transitional relief is provided to mitigate the cash flow impact of incremental corporate tax payable on the transition to the new rules. If paragraph 34.2(11)(b) applies in a taxation year that follows a year in which the corporation had nil income, then paragraph 34.2(11)(b) produces inequities by restricting the deductibility of the reserve in the year and thereafter in each year in

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11 If C makes a designation under variable "F" in its return of income for its 2012 taxation year to reduce its ASPA to the amount of its pro-rated actual 2013 income, then the issue is largely resolved. In this example, however, the unexpected work stoppage occurs after the deadline for C to make such a designation in its 2012 return and so C cannot engage in "self-help" by making a designation.

12 The Technical Notes state that paragraph 34.2(11)(b) "generally applies to limit a corporation's deduction in cases where the corporation's deduction under the subsection for a preceding taxation year is limited by the application of paragraph 34.2(11)(c)." Paragraph 34.2(11)(b) could be construed differently. It could be interpreted so as not to apply in a taxation year that follows a year in which the Income Limit was nil, on the basis that no reserve was deductible for the immediately preceding taxation year.

the transitional period. This is unfair, as the inability to deduct the reserve in the prior year was not the result of an exercise of discretion by the corporation.

Recommendation –

Paragraphs 34.2(11)(b) and (c) should be eliminated to achieve the policy objectives of the new rules more fairly.

5.2.3. Paragraphs 34.2(11)(b) and (c) – Unusually Low Income due to Short Taxation Year

A taxpayer's income for a year could be low by reason of an event that deems its taxation year to end prematurely (a "**Short Taxation Year**"). A Short Taxation Year may be caused by an acquisition of control of the corporation,[13] an amalgamation[14] or a change in status as a "Canadian-controlled private corporation" ("**CCPC**").[15]

Paragraphs 34.2(11)(b) and (c) produce anomalous results because a corporate partner's reserve deduction in a taxation year can be unduly restricted by unusually low income for the immediately preceding year that is attributable solely to a Short Taxation Year. Consider the following illustrative example:

- C is a corporation that has a calendar taxation year.
- P is a general partnership that has a fiscal period ending on June 30.
- C's only source of income is a significant interest in P.
- On May 1, 2012, there is an acquisition of control of C. C's taxation year is deemed to end at the last moment on April 30, 2012.[16]
- C's qualifying transitional income is not increased under subsections 34.2(16) and (17) as the conditions under subsection 34.2(16) are not met because P does not have a fiscal period ending in C's April 30, 2012 taxation year.

As illustrated below, C has an Income Limit of nil for its April 30, 2012 taxation year and as a result C is not entitled to deduct a reserve under paragraph 34.2(11)(c) for such year. Further, while subparagraph 34.2(11)(b) is ambiguous,[17] it could be construed so as to deny C a reserve deduction in its subsequent taxation years in the transition period.

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13 Subsections 256(9) and 249(4).
14 Paragraph 87(2)(a).
15 Subsection 249(3.1).
16 Subsections 256(9) and 249(4).
17 Supra note 12.

Year ended April 30		2012					
Year ended December 31	2011		2012	2013	2014	2015	2016
S. 96(1) income allocated from P for fiscal period ended June 30(A)	1,000	-	1,000	1,000	1,000	1,000	1,000
S. 34.2(2) add: adjusted stub period accrual = (A) * 183/365 (note 1)	501	-	501	501	501	501	501
S. 34.2(4) deduct: prior year adjusted stub period accrual	-	(501)		-	(501)	(501)	(501)
Net partnership income accrual for the Stub Period	501	(501)	501	501	-	-	-
Income before transitional reserve (B)	1,501	(501)	1,501	1,501	1,000	1,000	1,000
S. 34.2(11) deduct reserve for year (note 2)	(501)	-		-	-	-	-
S. 34.2(12) add: prior year's reserve (C)	n/a	501		-	-	-	-
C's income for tax purposes	1,000	-	1,501	1,501	1,000	1,000	1,000

Note 1

For 2011, C's QTI includes its adjusted stub period accrual in respect of P, which is based on P's income for the fiscal period ended January 31, 2011, *i.e.,* QTI = $1,000 x 334/365 = $915.

Note 2

The deduction under s. 34.2(11) is equal to the least of:

(a) Specified percentage x QTI	501	426		326	226	125	-
(b) Prior year reserve	n/a	501		426	-	-	-
+ positive "true-up"	n/a	n/a		n/a	n/a	n/a	n/a
	n/a	501		426	-	-	-
(c) Income Limit (B) + (C)	1,501	-		1,501	1,000	1,000	1,000
S. 34.2(11) reserve	501	-		-	-	-	-

A corporate member of a partnership should not be denied a reserve deduction on the basis of a subsequent event that does not affect the computation of the income of the corporation for its first taxation year ending after March 22, 2011. To deny the reserve in these circumstances is inconsistent with the policy of relieving the cash flow impact of incremental tax payable arising on the transition to the new rules.

Recommendation –

Eliminate paragraphs 34.2(11)(b) and (c).

5.2.4. Subparagraph 34.2(13)(c)(i) - "Principally Carries on the Activities to Which the Reserve Relates"

Subparagraph 34.2(13)(c)(i) prohibits the deduction of a reserve by a corporation in a taxation year if the year ends immediately before another taxation year of the corporation at the beginning of which the partnership no longer principally carries on the activities to which the reserve relates.

5.2.4.1. Meaning of "Activities"

The word "activities" is ambiguous and may lead to inequities. Consider the following example:

- A partnership realizes a taxable capital gain on a disposition of capital property in its fiscal period that ends in a corporate partner's first taxation year that ends after March 22, 2011.

- The taxable capital gain is more than half of the partnership's total income in the period.

- The taxable capital gain is a component of adjusted stub period accrual under Variable "A" of paragraph (a) of the definition of that term in subsection 34.2(1) and thus affects qualifying transitional income under subparagraph (b)(ii) of the definition of that term in subsection 34.2(1).

It is unclear if the partnership can principally carry on the activities to which the reserve relates in subsequent taxation years of the corporate partner, as the disposition of capital property was a one-time event. Subparagraph 34.2(13)(c)(i) is patterned on former subparagraphs 34.2(6)(b)(i) and (c)(i). The issue did not arise under these provisions because taxable capital gains were not included in the accrual under the 1995 amendments.

The issue also arises where qualifying transitional income is attributable to business income but the partnership's business evolves. Consider the following examples:

- A partnership carries on the business of designing and producing paging devices in its fiscal period that ends in a corporate partner's first taxation year that ends after March 22, 2011.

- Over time, consumer tastes change and the market no longer supports production of pagers.

- The partnership continues in business but responds to market changes by designing and producing tablet computers and distributing these using market channels similar in nature to its existing pagers business.

It is unclear whether the partnership principally carries on the activities to which the reserve relates in subsequent taxation years of the corporate partner, as the partnership no longer makes pagers but now makes tablet computers. A similar ambiguity arose under former subparagraphs 34.2(6)(b)(i) and (c)(i).

In a resource context, if QTI relates to income earned from particular resource properties and in the course of acquisitions and divestitures (which are very common) the particular resource properties change over time, will this test be satisfied? A similar issue applies for real estate development activities.

Fluid adjustment to market conditions by Canadian businesses has contributed to Canada's relative economic health in comparison to many of its major trading partners. An "activities" test in subparagraph 34.2(13)(c)(i) impairs Canadian businesses' ability to adapt to market changes.

Moreover, the policy objective of the provision is unclear. In particular, why are the current activities of the partnership relevant to the deductibility of the reserve if the purpose of the reserve is to allow the cash flow impact of the new rules to be spread over several years?

Recommendation –

We recommend the following:

1 Eliminate paragraph 34.2(13)(c).

2 If not eliminated, subparagraph 34.2(13)(c)(i) should focus on whether the partnership carries on the same or similar "business" or holds the same or similar "property" as that to which the reserve relates.

3 If not eliminated, add a deeming rule to broaden the meaning of "business" and "property" to include another business or property substituted therefore or for which the particular business or property was substituted. A precedent for such a deeming rule is former subsection 34.2(3).

4 If not eliminated, clarify that subparagraph 34.2(13)(c)(i) does not apply to the portion of qualifying transitional income that is attributable to taxable capital gains or any other "activities" that are not typically thought of as being "carried on."

5.2.4.2. Meaning of "Principally"

In other contexts, the Canada Revenue Agency interprets "principally" as 50 percent or more or primary or main.[18] We expect that a similar interpretation would apply to subparagraph 34.2(13)(c)(i). In this context, it is unclear whether the rule prohibits the reserve where more than half of the partnership's current activities are different than its historical activities to which the reserve relates.[19] Consider the following example:

- A partnership carries on the business of designing and producing paging devices in its fiscal period that ends in a corporate partner's first taxation year that ends after March 22, 2011.
- Over time, the market for consumer electronics booms.
- The partnership continues to make pagers in the same quantities as before.
- The partnership responds to market changes by designing and producing tablet computers in far greater quantities than pagers.

It is unclear whether the partnership no longer "principally" carries on the activities to which the reserve relates, as more than half of its activities now consist of making tablet computers even though it continues to make pagers in the same volume as before.

Recommendation –

Eliminate subparagraph 34.2(13)(c)(i) or, failing that, amend it to clarify that the reserve is not denied by reason that the partnership augments its activities to carry on activities that are different from those carried on by the partnership at the time qualifying transitional income was established.

5.2.5. Paragraph 34.2(13)(a) and Subsection 34.2(18) – Anti-Avoidance Rule

Paragraph 34.2(13)(a) denies the reserve deduction unless the corporation is a member of the partnership continuously since before March 22, 2011 to the end of the year.

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[18] For example, see CRA document nos. 2009-0307931E5, dated November 5, 2009; 2004-0063481E5, dated July 12, 2004.; 9200145, dated February 27, 1992; and 9808635, dated July 22, 1998.

[19] A similar issue arises if a partnership has two separate businesses that each contribute to qualifying transitional income but the partnership disposes of one of the businesses during the transitional period.

Subsection 34.2(18) provides that, if it is reasonable to consider that one of the main reasons a corporation is a member of a partnership in a taxation year is to avoid the application of subsection (13), the corporation is deemed not to be a member of the partnership for purposes of that subsection.

A corporation may wish to wind-up a partnership but these rules require the partnership to be maintained. It is unclear what policy objective is served by imposing this constraint. Moreover, a corporation may have a number of reasons for retaining a partnership interest, one of which may be to preserve the deductibility of the reserve. In these cases, the corporation may be vulnerable to the application of subsection 34.2(18). It is unclear what policy objective is served by this rule.

The rule in subsection 34.2(18) presumably is intended to deny a reserve deduction by a corporation that substantially withdraws from a partnership in the transition period but retains a small stake solely to satisfy paragraph 34.2(13)(a). Subsection 34.2(18) should be circumscribed so that the rule fulfils its intended policy objective without overreaching.

Recommendation –

If paragraph 34.2(13)(a) is not eliminated, amend subsection 34.2(18) to apply if a corporate partner disposes of substantially all of its partnership interest and "the main reason" (not "one of the main reasons") that the corporation retains its residual stake is to qualify for the reserve.

5.3. Single-Tier Alignment Election and Multi-Tier Alignment Election

Subsections 249.1(8) and (9) permit a single-tier alignment election and a multi-tier alignment election, respectively. On the basis of an election, the fiscal period of the partnership may be changed.

5.3.1. Paragraph 249.1(10)(a) – Deadline to Elect

Under paragraphs 249.1(8)(f) and (9)(c), a single-tier alignment election and a multi-tier alignment election, respectively, is valid only if subsection 249.1(10) applies.

Paragraph 249.1(10)(a) requires a corporation to file the election in writing and in prescribed form by the earliest filing-due date of any corporation that is a member of the partnership for its first taxation year ending after March 22, 2011.

The deadline is too short. For a partnership that has a corporate partner with a March 30 taxation year-end, the time to make the election has expired. Other corporate partners whose filing-due dates precede the enactment of the new rules and the promulgation of the prescribed form are required to elect without a prescribed form on the basis of draft legislation that may be subject to change. Elections may have been made prior to finalization of these rules on a protective basis, and taxpayers who have made such elections should have a one-time opportunity to revoke them if any changes are made to the rules.

An election reduces compliance costs and eliminates the risk of an innocent mistake that results in an income inclusion under subsection 34.3(3) for under-reported stub period accrual. For these reasons, elections ought to be encouraged. The short deadline to elect impedes elections and therefore frustrates what we assume are some of the policy objectives of subsections 249.1(8) and (9).

Recommendation –

Extend the deadline in paragraph 249.1(10)(a) to make an election to the later of the period contemplated in Bill C-13 and a reasonable period such as 12 months after Royal Assent. Allow elections filed before Royal Assent to be revoked within a reasonable period such as 12 months after Royal Assent.

5.3.2. Preamble to Subsection 249.1(8), Paragraph 249.1(8)(e) and Subparagraph 249.1(10)(a)(i)

If certain conditions are met, a single-tier alignment election can be made to change the fiscal period of a partnership. The election can be made only in respect of the fiscal period of the partnership that includes March 22, 2011, and cannot end after the first taxation year of a partner ending after March 22, 2011. The election is denied under paragraph 249.1(10)(b) if, as a consequence of the election, the fiscal period of the partnership to which the election applies exceeds 12 months.

As currently drafted, the rule does not allow an alignment for the first fiscal period of the partnership that ends after March 22, 2011 unless the corporation's first taxation year ending after March 22, 2011 ends before the partnership's fiscal period.

It is not possible to elect to align a fiscal period of a partnership to a December 31, 2011 taxation year of a corporate partner unless the partnership's fiscal period ends within the period from January 1, 2012 to March 22, 2012. Accordingly, the election is denied in common situations without a compelling reason. Consider the following illustrative example:

- C is a corporation that has a calendar taxation year.
- P is an existing general partnership that has a fiscal period-end of June 30.

A single-tier alignment election cannot be made. An election cannot be made to end the fiscal period of P on December 31, 2010, as the day specified in the election must be after March 22, 2011. Further, an election cannot be made to end on December 31, 2011 the fiscal period of P that began on July 1, 2010, as the resulting fiscal period of P would exceed 12 months, nor can the fiscal period that began on July 1, 2011 be made to end on December 31, 2011, since that period did not begin before March 22, 2011.

Further, as part of the 1995 amendments, an individual on behalf of a partnership was allowed to elect to retain an off-calendar fiscal period for a business.[20] The individual on behalf of the partnership was then entitled in a later fiscal period to make a one-time election to revoke the initial election and revert to a calendar fiscal period for the business.[21] The initial election and the revocation election gave a partnership the flexibility to retain its existing fiscal period. Many

[20] Subsection 249.1(4). The election also applied to an individual carrying on a business.
[21] Subsection 249.1(6).

partnerships then subsequently realized that the initial decision to retain an off-calendar fiscal period created undue complexity for their partners and a revocation election was subsequently made. If the members of a partnership realized they made a mistake in making the initial election, the rules allowed them to rectify the mistake.

The new rules for a single-tier alignment election do not provide similar flexibility. We believe corporate partners should be afforded similar flexibility.

An election reduces compliance costs and eliminates the risk of an innocent mistake that results in an income inclusion under subsection 34.3(3) for under-reported stub period accrual. For these reasons elections ought to be encouraged. The inability of many corporate partners to make a single-tier alignment election defies the policy objectives of subsection 249.1(8). The rule impedes elections in inappropriate circumstances. While an application under subsection 249.1(7) to change the fiscal period of P could be made, the corporate partners of P would not be entitled to a reserve deduction in respect of eligible alignment income as no election under subsection 249.1(8) would have been made.

Recommendation –

Allow a single-tier alignment election to be made at any time, without restriction. In the alternative, consider whether a corporation should be entitled to elect to change its taxation year to align to a fiscal period of a partnership.

5.3.3. Paragraph 249.1(1)(c) – Calendar Fiscal Period for Tiered Partnerships

Paragraph 249.1(1)(c) and subsection 249.1(11) require all tiered partnerships in a multi-tier structure to have a calendar fiscal period if a corporation has a significant interest in each of the partnerships, unless a multi-tier alignment election has been made to adopt an off-calendar fiscal period for the partnerships. A multi-tier alignment election is not available for newly formed multi-tier arrangements once the short deadline for making a multi-tier alignment election has expired. The time to elect expires in all cases on September 22, 2012, and in many cases much earlier.

Commercial considerations, such as the business cycle and workflow management, may dictate that a multi-tier alignment election is optimal to allow an off-calendar fiscal period for multi-tier partnership structures formed after the deadline. Indeed, a mandated December 31 fiscal period end may cause a "misalignment" with partner year ends.

Recommendation –

Amend subsection 249.1(10) to not apply where all of the tiered partnerships share a common fiscal period end and indefinitely extend the deadline to make a multi-tier alignment election to permit all partnerships in a multi-tier structure to have an off-calendar (but same) fiscal period.

5.3.4. Paragraph 249.1(9) – Multi-Tier Alignment Elections

Where a partnership owns a small interest in another partnership in which a corporation holds a significant interest (or *vice versa*), the partnership could be forced into a calendar fiscal period under paragraph 249.1(1)(c) even though there is no "significant interest" nexus between the two partnerships.

Consider the following example:

- C1 is a corporation that has a taxation year ending on June 30.
- C2 is a corporation that has a calendar taxation year.
- C3 is a corporation that has a November 30 taxation year.
- C1, C2 and C3 deal with each other at arm's length.
- P1 is a partnership that has a fiscal period ending on January 1.
- P2 is a partnership that has a fiscal period ending on January 31.
- C1 has a 99 percent partnership interest in P1, and C2 has a 1 percent partnership interest in P1.
- C3 has a 99 percent partnership interest in P2, and P1 has a 1 percent partnership interest in P2.
- C1 wishes to align the fiscal period of P1 to its June 30, 2011 taxation year to reduce the cost of compliance caused by the new rules. C3 wishes to adopt the fiscal period of P2.

Without a multi-tier alignment election, paragraph 249.1(1)(c) and subsection 249.1(11) appear to apply to cause the fiscal periods of P1 and P2 to become a calendar fiscal period. The policy of section 34.2 is to limit deferral of corporate tax where there is a "significant interest" nexus between a corporation and a partnership. To require partnerships with a *de minimis* connection to align their fiscal periods or to adopt a calendar fiscal period overreaches the policy objectives of the provision and unduly interferes with commercial practice.

Recommendation –

Paragraph 249.1(1)(c) and subsection 249.1(11) should be clarified to only require the fiscal periods of two or more partnerships to align to a calendar fiscal period if one partnership has a significant interest in another partnership and even then only if the partnerships do not have a common fiscal period end.[22]

5.4. Paragraph 34.2(5)(a) – Sourcing

5.4.1. Paragraph 34.2(5)(a) – Acquisition of Control

Subsections 34.2(2) and (4) require a corporate partner to include adjusted stub period accrual in income in a taxation year and permit the corporation to deduct such amount in the following

[22] This might be accomplished by an amendment to the definition of "significant interest" in subsection 34.2(1) so that it applies to an interest of a partnership in another partnership.

taxation year, respectively. Subsection 34.2(11) allows a deduction of a reserve in respect of QTI in a taxation year, and subsection 34.2(12) requires the reserve deducted in the year to be added back into income in the following taxation year.

The deduction under subsection 34.2(4) may result in a corporation realizing a loss (e.g., if actual partnership income declines or if there is an acquisition of control so that the taxation year in which the deduction is taken is not the taxation year in which the income allocation from the partnership occurs). It is not clear how such a loss would be characterized for purposes of the rules in subsections 111(4) and (5). Moreover, because the subsection 34.2(2) amount is an estimate of income that is "trued up" in the taxation year in which the income from the partnership is in fact earned any such loss should not be subject to the same restrictions as other losses following an acquisition of control of the corporation.

Consider the following example:

- C is a corporation that has a December 31 taxation year.
- P is a partnership that has a June 30 fiscal period.
- C becomes a member of P on July 1 2011 and has a significant interest in P. P is its only source of income.
- C's income allocation from P is $100 each year but in 2012 there is also a taxable capital gain of $50.
- C does not make a designation under subsection 34.2(3) to include an amount in income for its 2011 taxation year.

With no acquisition of control, C's taxable income would be computed as follows:

Year ended December 31	2011	2012	2013	2014	2015	2016
S. 96(1) income allocated from P for fiscal period ended June 30 (A) (note 1)	-	150	100	100	100	100
S. 34.2(2) add: adjusted stub period accrual = (A) * 184/365	-	75	50	50	50	50
S. 34.2(4) deduct: prior year adjusted stub period accrual (note 2)	-	-	(50)	(50)	(50)	(50)
C's income for tax purposes (note 3)	-	225	100	100	100	100
S. 111(1)(a) deduct carry back of allowable capital loss (note 4)	-	(25)	-	-	-	-
C's taxable income for the year	-	200	100	100	100	100

Note 1
C does not make a designation under subsection 34.2(3).
Note 2
$25 of the deduction allowable under subsection 34.2(4) is characterized as an allowable capital loss under paragraph 34.2(5)(b). This amount is not deductible in 2012 because C has no taxable capital gains realized in that year but is deemed an allowable capital loss under paragraph 34.2(5(b).
Note 3
C is not entitled to a reserve under subsection 34.2(11) as it does not have qualified transitional income.
Note 4
The deemed allowable capital loss realized is 2013 is carried back to 2012.

If there were an acquisition of control of C on January 1, 2013 the following would result:

Year ended December 31	2011	2012	2013	2014	2015	2016
S. 96(1) income allocated from P for fiscal period ended June 30 (A) (note 1)	-	150	100	100	100	100
S. 34.2(2) add: adjusted stub period accrual = (A) * 184/365	-	75	50	50	50	50
S. 34.2(4) deduct: prior year adjusted stub period accrual (note 2)	-	-	(50)	(50)	(50)	(50)
C's income for tax purposes (note 3)	-	225	100	100	100	100
S. 111(1)(a) deduct carry back of allowable capital loss (note 4)	-	-	-	-	-	-
C's taxable income for the year	-	225	100	100	100	100

Note 1

C does not make a designation under subsection 34.2(3).

Note 2

$25 of the deduction allowable under subsection 34.2(4) is characterized as an allowable capital loss under paragraph 34.2(5)(b). This amount is not deductible in 2012 because C has no taxable capital gains realized in that year but is deemed an allowable capital loss under paragraph 34.2(5(b).

Note 3

C is not entitled to a reserve under subsection 34.2(11) as it does not have qualified transitional income.

Note 4

The deemed allowable capital loss realized is 2013 cannot be carried back due to the acquisition of control on January 1, 2013.

However, C should be entitled to carry back the deemed allowable capital loss of $25 to offset the notional taxable capital gain of $25 included in the subsection 34.2(2) income inclusion of $75 for its 2012 taxation year. Otherwise that notional taxable capital gain is never reversed out of income. A carry forward of the loss is not adequate both because a capital gain may never be realized and because the $25 accrual in 2012 is not real income. However, it appears this allowable capital loss carry-back is not permitted based on the current version of the new rules contained in Bill C-13 combined with existing subsection 111(4).

A similar issue arises for a non-capital loss from a property source or from carrying on a business where, for instance, the "throughout the particular year" test in subparagraph 111(5)(a)(i) is not met in a year following an acquisition of control because the interest in the partnership is sold in that year.

Recommendation –

Amend subsection 34.2(5) to add the following additional paragraphs:

(c) where at any time control of a corporation is acquired by a person or group of persons, subsection 111(4) shall not apply to a net capital loss realized by the taxpayer in its first taxation year ending after that time to the extent such loss may reasonably be regarded as being attributable to the capital loss deemed realized by the taxpayer in such year pursuant to paragraph (b);

(d) where at any time control of a corporation is acquired by a person or group of persons, and the corporation realizes a non-capital loss in its taxation year ending immediately before that time or in its first taxation year ending after that time then, notwithstanding subsection 111(5), the corporation may deduct such portion of that non-capital loss as may reasonably be regarded as being attributable to the deduction, in a preceding taxation year or the following taxation year (each a "deduction year"), of an amount under subsection (4) or **(11)** in respect of a particular qualifying partnership**,** to the extent that in the deduction year the corporation included an amount in income pursuant to subsection (2), (3) or (12) or subsection 96(1) in respect of the particular qualifying partnership.

A consequential amendment to subsection 256(7) should also be made.

5.4.2. Paragraph 34.2(5)(a) – Impact on Tax Attributes

Paragraph 34.2(5)(a) deems amounts included or deducted in computing the income of a corporate partner, as the case may be, under section 34.2 to retain their "character" and to be in the same proportions as business income, property income and taxable capital gains of the partnership to which they relate.

A policy objective of subsection 34.2(5) appears to be to ensure that the computation of business income, property income and taxable capital gains by a corporate partner is not distorted by the accrual and deduction of stub period income and the transitional reserve, such that amounts covered by section 34.2 are taxed at the appropriate corporate tax rate.

The rules likewise ought to mitigate distortions to tax attributes of a corporate partner, such as refundable dividend tax on hand,[23] capital dividend account,[24] general rate income pool,[25] low rate income pool[26] and safe income.[27] In this regard, the Explanatory Notes[28] provide as follows:

> For example, if a corporation receives $100,000 of partnership income for the partnership's fiscal period ending in its taxation year, and that income is composed of $40,000 of active business income, $30,000 of income from property, and $30,000 as a taxable capital gain, the corporation's adjusted stub period accrual in respect of the partnership would be 40% active business income, 30% property income and 30% taxable capital gains. In the case of a taxable capital gain, no amount would be a "capital gain from a disposition" included in the corporation's capital dividend account under the definition "capital dividend account" in subsection 89(1) of the Act.

We question whether that result is obtained under the deeming rule.

Further, it is not clear that paragraph 34.2(5)(a) prevents the distortion of the calculation of refundable dividend tax on hand, general rate income pool, low rate income pool and safe income. Anomalies can arise if paragraph 34.2(5)(a) applies to the computation of these accounts. Consider the following example:

- C is a corporation that has a calendar taxation year.
- P is a partnership that has a fiscal period ending on January 1.

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[23] Defined in subsection 129(3).
[24] Defined in subsection 89(1).
[25] Defined in subsection 89(1).
[26] Defined in subsection 89(1).
[27] Relevant to subsection 55(2).
[28] Canada, Department of Finance, *Explanatory Notes in Respect of Legislative Proposals Relating to the Income Tax Act and Related Regulations* (Ottawa: Queen's Printer, September 1, 2011).

- C’s only source of income is a 50 percent partnership interest in P.
- P has business income of $20 in each of its fiscal periods ending January 1, 2011 through January 1, 2016, except that it also has investment income of $10 in its fiscal period ended January 1, 2013.

C’s qualifying transitional income is initially equal to its adjusted stub period accrual for its 2011 taxation year, computed as follows:

$$[(A – B) \text{ x } C / D] – (E + F)$$

$$= (\$10 – 0) \text{ x } 364 / 365 – (0 + 0)$$

$$= \$9.97.$$

In the transition period, C is required to compute its income under section 34.2 in the manner tabulated below:

Year ended December 31	2011	2012	2013	2014	2015	2016
S. 96(1) income allocated from P for fiscal period ended January 1 (A)	10.00	10.00	15.00	10.00	10.00	10.00
S. 34.2(2) add: adjusted stub period accrual = (A) * 364/365 (note 1)	9.97	9.97	14.96	9.97	9.97	9.97
S. 34.2(4) deduct: prior year adjusted stub period accrual	-	(9.97)	(9.97)	(14.96)	(9.97)	(9.97)
Net partnership income accrual for the Stub Period	9.97	-	4.99	(4.99)	-	-
Income before transitional reserve (B)	19.97	10.00	19.99	5.01	10.00	10.00
S. 34.2(11) deduct reserve for year (note 2)	(9.97)	(8.48)	(6.48)	(4.49)	(2.49)	-
S. 34.2(12) add: prior year's reserve (C)	n/a	9.97	8.48	6.48	4.49	2.49
C's income for tax purposes	10.00	11.50	21.98	7.00	12.00	12.49
C's business income	10.00	11.50	11.99	11.99	12.00	12.49
C's investment income/(loss)	-	-	9.99	(4.99)	-	-
C's RDTOH	-	-	2.66	-	-	-

Note 1

For 2011, C's QTI includes its adjusted stub period accrual in respect of P, which is based on P's income for the fiscal period ended January 1, 2011, *i.e.,* QTI = $10 x 364/365 = $9.97.

Note 2

The deduction under s. 34.2(11) is equal to the least of:

(a) Specified percentage x QTI	9.97	8.48	6.48	4.49	2.49	-
(b) Prior year reserve	n/a	9.97	8.48	6.48	4.49	-
+ positive "true-up"	n/a	n/a	n/a	n/a	n/a	n/a
	n/a	9.97	8.48	6.48	4.49	-
(c) Income Limit (B) + (C)	19.97	19.97	28.46	11.49	14.49	12.49
S. 34.2(11) reserve	9.97	8.48	6.48	4.49	2.49	-

The amount of RDTOH that should be generated for the one-time investment income of $5.00 actually earned should be $1.33 ($10 x 50% x 26.67%). However, C has RDTOH of $2.66 because it has actual investment income of $5.00 and adjusted stub period accrual of $4.99. Nonetheless, it cannot recover RDTOH in respect of the investment loss realized in 2014 due to the deduction claimed under subsection 32.2(4) and the characterization of a portion of that deduction as a loss from property under subsection 32.4(5).

Detailed rules are required to adjust various tax attributes affected by the new rules. These detailed adjustments would necessarily involve undue complexity.

Recommendation –

Section 34.2 should not apply to the computation of the following:

1 the small business deduction under subsection 125(1);

2 aggregate investment income under subsection 129(4);

3 capital dividend account under subsection 89(1);

4 general rate income pool under subsection 89(1);

5 low rate income pool under subsection 89(1); and

6 safe income.

5.4.3. Reference to character is insufficient

Various provisions of the Act contemplate income from a particular source, or otherwise highly specific references such as to a particular property. We assume that the reference in subsection 34.2(5) to "character" is intended to mean that income to which that provision refers is considered to be identical to the actual partnership income on which it is based. However, this should be clarified, since "character" connotes a more general concept that could give rise to inappropriate results if that interpretation were to prevail. For example, the "successor" rules in section 66.7 may limit deductions in respect of "successored" property to, among other things, production from the particular property. It is not clear that income under section 34.2 would, by virtue of the same "character" rule in subsection 34.2(5), be considered to be income from a particular property, although that would appear to be the appropriate result from a policy perspective.

Recommendation –

Broaden subsection 34.2(5) to ensure that in any circumstances where it would be appropriate to apply, it has the intended effect. We recommend a thorough review of the Act rather than reliance upon a blanket catch all provision that may or may not be appropriate in all cases. (There are circumstances where we submit it would be inappropriate to apply this rule, as mentioned above.)

At a minimum, subsection 34.2(5) should be broadened to also provide that the various amounts referred to are deemed to have the same "source" as the amounts allocated by the partnership. For example, we recommend employing the following language in subparagraph 34.2(5)(a)(i), with corresponding changes to the remainder of subsection 34.2(5):

(i) an adjusted stub period accrual included under subsection (2) in respect of a partnership for the year is deemed to be income and taxable capital gains having the same character

> or source, and to be in the same proportions as any income and taxable capital gains that were allocated by the partnership to the corporation for all fiscal periods of the partnership ending in the year,

5.5. *Paragraph 34.2(8)(b) – Hybrid Surplus*

Paragraph 34.2(8)(b) provides that section 34.2 does not apply for the purposes of computing, for a taxation year of a foreign affiliate, except to the extent that the context otherwise requires, the exempt surplus or deficit and the taxable surplus or deficit of the affiliate.

Under existing rules, if a foreign affiliate realizes a capital gain on a disposition of a share of another foreign affiliate that is excluded property, one-half of the gain is included in its exempt surplus and the rest is included in its taxable surplus. The August 19, 2011 draft legislation proposes to introduce a new concept of "hybrid surplus" to cover such gains. Subsection 5907(1) defines "hybrid surplus" of a foreign affiliate by reference to the formula A – B; subparagraph (ii) of variable A refers to "the amount of a capital gain […], for a taxation year, of the subject affiliate, or of a partnership of which the subject affiliate is a member […] in respect of a disposition […]"

As the definition refers to a "disposition," we expect that Finance will adopt a view (similar to that in the Technical Notes for subsection 34.2(5) in respect of the computation of the capital dividend account) that section 34.2 does not affect the computation of hybrid surplus because, while the rules may deem the corporation to realize a taxable capital gain, they do not deem the corporation to have disposed of property.

Nevertheless, for the reasons set out above, it is unclear whether section 34.2 affects the computation of hybrid surplus of a foreign affiliate.

Recommendation –

Amend paragraph 34.2(8)(b) to add a reference to hybrid surplus of a foreign affiliate.

5.6. *Drafting Inconsistencies*

We have observed certain inconsistencies in the drafting of the provisions and would be pleased to work with you to remedy these as we believe the inconsistencies may lead to confusion in applying the legislation. A few examples may illustrate the concerns:

1 The definition of "adjusted stub period accrual" does not specify that it is for a taxation year, unlike the definitions of each of "qualified resource expense", "actual stub period accrual", "base year", "income shortfall adjustment", and "qualifying partnership." We recommend that the definition of adjusted stub period accrual be amended to read as follows: "'adjusted stub period accrual' of a corporation in respect of a partnership <u>for a taxation year</u> – in which the corporation […]."

2 The definition of "adjusted stub period accrual" in subsection 34.2(1) and "actual stub period accrual" in subsection 34.3(1), although intended to be very similar and to capture similar amounts, are drafted differently. For example, the words "to the extent that the total of all

allowable capital losses does not exceed the total of all taxable capital gains in the description of A" appear in the description of B in the definition of adjusted stub period accrual (and in the definition of "eligible alignment income"). Comparable words appear in the description of B of the definition “actual stub period accrual”: “to the extent that the total of all allowable capital losses included under this description in respect of all qualifying partnerships for the taxation year does not exceed the corporation's share of all taxable capital gains of all qualifying partnerships for the taxation year.” However, in the definition of adjusted stub period accrual, as in the definition of "eligible alignment income", the words appear between dashes and are followed by the words "of the partnership" while in the definition of "actual stub period accrual" the comparable words are in parentheses and follow the words "of the qualifying partnership". The meanings are quite different. In the latter case, the words in parentheses can be read as modifying "loss or allowable capital loss of the qualifying partnership" – that is, both ordinary losses and allowable capital losses – because the words follow that entire phrase. In the other definitions, where the relevant phrase is between dashes and the words "of the partnership" follow the second dash, the phrase modifies only allowable capital losses. We consider that, in both cases, the relevant phrase is intended to modify allowable capital losses only and recommend that the drafting approach be consistent.

3 In the context of a multi-tier alignment the definition of “eligible alignment income” of a corporation in subsection 34.2(1) means the amount determined by the formula A – B – C, as set out in paragraph (b) of the definition of that expression. A is the corporation’s income or taxable capital gain from the partnership that is subject to the multi-tier alignment for the “eligible fiscal period”, being the first aligned fiscal period of the partnership. C provides for a reduction to the extent of certain resource expenses incurred by the partnership and deemed to be incurred by the corporation under subsection 66(18) at the end of the eligible fiscal period. Similarly, B provides for a reduction for the corporation’s loss or allowable capital loss. However, as drafted, B does not refer to the losses of “the” partnership, but rather to “a” partnership. Given the structure of the definition of eligible alignment income and the reference in B to losses for the “eligible fiscal period”, we assume that this is merely a typographical error that should be corrected.