The Joint Committee on Taxation of
The Canadian Bar Association
and
The Canadian Institute of Chartered Accountants
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September 25, 2012

Mr. Brian Ernewein
General Director, Tax Legislation Division
Tax Policy Branch
Department of Finance
L'Esplanade, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON KIA 0G5

Dear Mr. Ernewein:

Re: Legislative Proposals Released on July 25, 2012

Enclosed is our submission on the July 25, 2012 draft legislative proposals to amend the *Income Tax Act* (Canada). We thank you for considering this submission and trust that you will find our comments helpful. We would be pleased to meet with you to discuss this submission further at your convenience.

Yours very truly,

Penny Woolford
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Darcy Moch
Chair, Taxation Section
Canadian Bar Association

Submission of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants regarding the Draft Legislation

On July 25, 2012, the Department of Finance released for public comment draft legislation (the "Draft Legislation") relating to a number of technical changes to the *Income Tax Act* (Canada) (the "Tax Act"), including the introduction of section 18.3 to address "stapled security" structures. This letter includes the Joint Committee's submissions on the Draft Legislation. Unless otherwise indicated, all statutory references are to provisions of the Tax Act.

A. Definition of "Security"

A "security" for the purposes of section 18.3 is defined to include, if the entity is a corporation, "a right to control in any manner whatever the voting rights of a share of the capital stock of the corporation". We believe that the scope of this definition is overly-broad in the context of the stapled security rules and could lead to unintended consequences. Where the holder of a right to vote does not have any economic entitlement in respect of the share, there does not appear to be any reason to apply the stapled security rules. Furthermore, it is not clear whether the reference to the right to control the voting rights of a share includes that right when it is part of the share itself (which "right" might be listed/traded if the share is listed/traded) or whether the "right" is a different security.

In the context of a conventional financing arrangement, a creditor or indenture trustee (for public notes or debentures) is sometimes provided with the right to vote shares held as security for a loan or debt (either immediately or in the future). If the debt itself is listed/traded and shares of a subsidiary are pledged as security, or if the debt is not listed/traded but the pledged shares are listed/traded, it is conceivable that the stapled security rules might apply to deny interest deductibility. This cannot have been intended. Similarly, holders of convertible debt are sometimes entitled to vote on certain matters on an as-converted basis; if that right is a security stapled to the convertible debt, the interest thereon would not be deductible. That too cannot have been intended.

It is not evident to us why a voting right that is designed to protect creditor rights, without economic entitlements, should cause a concern for the stapled security rules in section 18.3.

Recommendations

The definition of "security" should be amended to delete the reference to a right to control the votes in respect of a share. Failing that, in order to avoid inadvertent consequences to genuine commercial lending arrangements, a rule similar in effect to subsection 18(5.1) or subsection 256(6) should be introduced to deem the holder not to have a "right to control in any manner whatever the voting rights of a share of the capital stock of the corporation" where the particular right is clearly in place to safeguard the rights of a creditor, and does not replicate an equity interest. In any event, it should be clarified that a voting right is not considered a distinct security when it is simply one component of the bundle of rights of a holder of voting shares.

B. Definition of "Subsidiary"

The definition of "subsidiary" in subsection 18.3(1) includes a particular entity of which another entity holds securities that have a total fair market value greater than 10% of the equity value of the particular entity. A security, for this purpose, includes a liability; accordingly, one entity may become a subsidiary of another without any cross holding of equity. Moreover, the 10% threshold is extremely low and, when coupled with cross ownership of a "security" compared to "equity", may increase the likelihood that an entity will inadvertently become a subsidiary of another.

Recommendations

The determination of subsidiary status should be based on ownership of "equity" rather than ownership of debt or other "securities". This is consistent with the original announcement of these rules (see July 20, 2011 press release, footnote 3). Moreover, the 10% threshold should be raised to a higher amount, most appropriately more than 50%, to accord with the normal meaning of subsidiary. In any event, a transitional rule should be added whereby taxpayers may elect to apply the narrower definition (based on equity ownership only) for all periods prior to July 25, 2012.

C. FAPI

It is not clear whether the rules in section 18.3 are intended to apply for FAPI purposes. Pursuant to paragraph 95(2)(f), a foreign affiliate must calculate its FAPI as if it were a resident of Canada and, accordingly, may be subject to the rules in section 18.3. As a result, for example, where a Canadian corporate issuer of listed common shares has stapled debt of a foreign subsidiary, the foreign affiliate may be restricted in deducting the interest payable on the debt, for the purposes of computing its FAPI. Arguably this result runs contrary to the underlying policy of section 18.3. The rules in 18.3 are intended to augment and enhance the SIFT rules contained in the Tax Act. The SIFT rules and the REIT rules are designed to ensure that "non-portfolio earnings" (which generally do not include foreign earnings) are subject to entity level taxation, and they do not generally apply to foreign source income. Consequently, the rules in section 18.3 should not limit a deduction that relates to non-Canadian income.

Recommendation

Section 18.3 should not apply in determining the FAPI of a foreign affiliate (except to the extent that the FAPI consists of Canadian source income).

D. Excluded Subsidiary Entity

The definition of "excluded subsidiary entity" in subsection 122.1(1) will be amended to expand the list of permitted holders of equity of a subsidiary entity for the purpose of that definition. We understand that this amendment was intended to address a situation where a private trust or partnership could be treated as a SIFT by virtue of the public status of one of its beneficiaries or partners. Although the amendment is helpful in this regard, we believe that the strict requirement, that the holder not have any property in connection with the holding of a security of the entity any portion of the value of which is determined by reference to any security that is listed or traded on a stock exchange or other public market, is too stringent. For example, where the private trust or partnership owns a listed share or debt of an issuer that is independent of the public entity that holds an interest in the private trust or partnership (and which causes the SIFT issue for the trust or partnership in the first place), it will be difficult to conclude that no part of the value of the trust or partnership interest held by the public entity is determined by reference to that listed share or debt. We observe that the July 20, 2011 Backgrounder indicated that the concern was with trust or partnership interests that are exchangeable for, or convertible into, listed securities or exchangeable for property "the fair market value of which is determined primarily by reference to" listed securities. There is a significant difference between "determined primarily by reference to" and "determined, all or in part, by reference to". Similarly, the examples in the Technical Notes that accompanied the draft legislation do not use the "all or in part" language and suggest the value of the listed security should form a significant part of the analysis.

Recommendation

The proposed amendment to the excluded subsidiary entity test should be clarified to require a link between the listed/traded entity that caused the SIFT status issue for the private trust or partnership and the listed/traded security that is described in proposed subparagraph (v) of excluded subsidiary entity. Alternatively, the proposal should disregard securities owned by the private trust or partnership in the determination of whether the "all or in part" test in that subparagraph is met.